



Robert M. Falzon, CFA
Executive Vice President and CFO

Prudential Financial, Inc.
751 Broad Street
Newark, NJ 07102
Tel 973-802-9257 Fax 973-802-9280
robert.falzon@prudential.com

Via E-Mail

September 16, 2016

Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551

Re: Advance Notice of Proposed Rulemaking on Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities (Docket No. R-1539 & RIN 7100 AE 53)

Ladies and Gentlemen:

Prudential Financial, Inc. ("Prudential", "we" or "our") appreciates the opportunity to provide comments to the Board of Governors of the Federal Reserve System (the "Board") on its advance notice of proposed rule rulemaking ("ANPR") related to capital requirements for supervised institutions significantly engaged in insurance activities, which includes insurers that are insured depository institution holding companies ("Insurance IDIs") and insurers that have been designated as nonbank systemically important financial institutions ("Insurance SIFIs"), such as Prudential.

Our comments on the ANPR are organized into four sections, as follows:

- A. General comments and the applicability of the two proposed capital approaches to insurance groups;
- B. Comments on the design of the proposed Building Block Approach ("BBA"), which we believe is viable for all Board-supervised insurers;
- C. Comments on the design of the proposed Consolidated Approach ("CA"), to the extent the Board decides to move forward with a separate regime applicable to Insurance SIFIs; and
- D. Considerations related to the timing of capital standards development and implementation.

A. General comments and the applicability of proposed capital approaches to insurance groups

Prudential supports the Board's goal to develop a regulatory capital framework appropriately tailored to the business of insurance and appreciates the thoughtful consideration given by the Board to existing and developing regulatory and accounting frameworks. In particular, Prudential appreciates the Board's

recognition of the unique risks and structure of insurance firms and the ways in which the nature of insurance assets, liabilities and regulation differ from banks and other financial institutions.

Consistent with the Board's stated supervisory objectives, any capital framework applied to an insurance institution should be designed to ensure that the institution has sufficient and available loss-absorbing resources to continue operations as a going concern (and absorb losses as they are actually realized) throughout times of economic, financial and insurance-related stresses, most importantly taking into account its actual risk profile. The satisfaction of these objectives is critical to enable the capital framework ultimately adopted by the Board to provide an accurate and meaningful depiction of an insurance group's solvency position.

Prudential believes that certain key principles and considerations, discussed in further detail in this letter, are paramount when designing a capital framework that can satisfy such supervisory objectives and be appropriately tailored to the unique risks and structure of insurance firms:

- *Holistic view of loss absorption capacity.* All tangible loss-absorbing resources should be counted as qualifying capital for any insurance capital framework, whether those resources are "traditional" capital, held as reserves or otherwise available to absorb losses. A life insurer's reserves consist of (1) the "best estimate" of the present value of net future benefit payments and (2) a "margin" to cover unexpected losses that is embedded in reserves calculated under both statutory and GAAP accounting principles. As the purpose of these margins is precisely to provide additional resources to absorb losses that might exceed "best estimates," margins need to be appropriately reflected as qualifying capital in any insurance capital framework.
- *Insurance-specific risks and diversification.* Risk factors and segments must reflect the unique products, businesses, and risk profiles of insurance companies. Capital requirements derived from overly broad or simplistic risk segments can result in a misleading representation of an insurance group's capital position. The state insurance risk-based capital system ("RBC") already includes a set of granular risk segments and charges that reflect the diversity of insurance products and features, and that has been developed and tested successfully over decades of insurance regulatory oversight. Any new capital framework should leverage the existing system applied to U.S. insurers. In addition, the amount of risk capital required to withstand insurance shocks (e.g., mortality, longevity, lapse, natural catastrophes, etc.) should reflect the benefit of diversification between insurance risks and other risks, such as financial risks. Any capital framework should be appropriately calibrated to reflect the probability of concurrent insurance and market and other economic stresses.
- *Insurance product design and other risk mitigants.* Certain insurance products contain structures and/or features that pass risk on to the policyholder (e.g., separate account products and participating insurance policies). These generally pose no or significantly reduced solvency risk for insurers, and any capital framework should be designed to appropriately factor in the actual risks (or lack thereof) of such products. In addition, certain insurance contract features are designed to prevent or mitigate the risk of surrenders or withdrawals, which should also be factored into the applicable risk weights and factors. As a general matter, prudent risk mitigation needs to be recognized in any capital framework to the extent it actually reduces or offsets risk, including asset-liability management, insurance contract design features, diversification, reinsurance, hedging and other risk mitigants.
- *Asset-liability matching and the long-term nature of insurance liabilities.* The risk and supporting reserve/capital structure of insurance companies are strongly liability-centric, with a heavy focus on asset-liability management and conservatism (especially in the establishment of liabilities). Any capital framework should recognize the asset-liability

management that underpins the insurance business model. Insurers invest in high quality assets and hold them to maturity to support generally long-term insurance liabilities. Accordingly, market value changes should only be relevant to the extent that an asset is bought or sold. It is essential that any capital framework provide for the valuation of assets and liabilities on a consistent basis, for example, by excluding from qualifying capital any unrealized gains or losses on investments.

- *Capital mobility restraints and the non-fungibility of capital.* Capital is a resource and should not be presumed to be fungible. Capital adequacy rules need to be designed to recognize the limits on capital mobility across different parts of the insurance group. In light of this structural feature of insurance groups, requiring an insurance holding company to be a “source of strength” for its insurance subsidiaries would be inappropriate and unnecessary.

We acknowledge that it is feasible to construct a capital standard that reflects these features using various frameworks, including a BBA or a CA, and we provide considerations for both approaches in this letter. As discussed below, we believe that the BBA has a practical advantage over the CA due to its reliance on already developed, well-defined and time-tested regulatory regimes. Nevertheless, of utmost importance is ensuring the framework serves as an appropriate and meaningful depiction of an insurer’s solvency position, preserving the existing robust insurance business models and markets, through careful and measured development efforts, and applying a single standard to all Board-supervised insurers.

In line with the key principles and considerations summarized above and the Board’s goal to develop a capital framework tailored to the business of insurance, Prudential supports the Board’s conclusion that the application of existing capital requirements for banking organizations would not be appropriate for firms significantly engaged in insurance activities. Prudential further concurs in the Board’s determination that the application of a market-based valuation approach to insurance capital requirements, as embodied in the European Solvency II framework and certain proposals advocated by the International Association of Insurance Supervisors (“IAIS”), is not appropriate for Board-supervised insurers. As the Board recognizes, a Solvency II approach would not adequately account for U.S. generally accepted accounting principles (“GAAP”)¹ and could introduce excessive volatility due to discount rate assumptions. In addition, we believe the Board is correct to point out that the application of a regime similar to Solvency II, or a regime based on certain current proposals of the IAIS (as members and staff of the Board have indicated elsewhere), would not be achievable in the short-to-medium term. Designing a framework that leverages the existing and time-tested accounting and solvency standards applied to insurers in the United States, i.e., RBC, would, on the other hand, lead to a capital framework that is executable in the short-to-medium term, comparable across Board-supervised insurers, and designed to measure specific insurance risks, none of which would likely be achievable through the application of a distinctly different (and relatively untested) framework such as Solvency II.

Prudential believes it is essential to understand certain features of how insurance companies are structured and regulated in order to appropriately tailor any group capital framework to the business of insurance. U.S. insurance entities are highly regulated under existing regimes specifically designed by insurance regulators for application to insurance entities and to protect policyholders and limit the risk insurance companies could pose to the financial system. U.S. insurance entities are subject to strict capital requirements under the RBC system, which operates to ensure companies hold capital commensurate with the relative riskiness of their assets and liabilities, and which mandates a minimum level of capital and provides a basis for ladderred supervisory intervention based on a given insurance entity’s RBC level. Insurers are also required to hold reserves for insurance obligations based on prudent actuarial and other relevant assumptions. RBC is built on the principles of statutory accounting, where both assets and liabilities are valued conservatively. Statutory accounting is oriented to take into account the long-term nature of insurance obligations, and is primarily focused on the ability of the insurance company, through asset-liability matching

¹ Or, for that matter, U.S. statutory accounting principles.

and other tools, to satisfy all of its obligations on a timely basis even under adverse scenarios, thereby incentivizing companies to invest appropriately for the long term. It intentionally does not apply fair value accounting rules to most life insurance company assets and liabilities, thereby avoiding unwarranted volatility in regulatory capital. Such short-term volatility is a source of “noise” and would be inappropriate to reflect in regulatory capital, particularly for life insurers with long-term and inherently stable liability structures and attendant buy-and-hold investment strategies to support their liabilities.

In addition, the “source of strength” model that applies to bank holding companies is simply not applicable to insurance holding companies with respect to their insurance company subsidiaries. The ANPR states, however, that the “parent [insurance] holding company should be a source of capital strength to the entire entity, including to the subsidiary insurance companies” Insurance holding companies typically do not conduct any business and limit their operations to certain general corporate activities and to the issuance of debt to finance operating subsidiaries; as a result, the holding company is typically not, and is not required by regulators to be, a source of strength for its subsidiaries (absent contrary contractual arrangements or regulatory undertakings). Rather, insurance holding companies often rely on cash distributions from their operating subsidiaries to meet their limited cash flow and liquidity needs. Requiring insurance holding companies to be a “source of strength” for their insurance subsidiaries would represent a fundamental departure from historical and existing insurance company regulation for no apparent benefit.

Under the state (and, generally, foreign) insurance laws to which Board-supervised insurers are subject, insurance subsidiaries are in many cases not permitted to transfer funds to affiliates (including the ultimate holding company) without approval of insurance regulators or satisfaction of certain regulatory tests. Accordingly, the fungibility of capital and the location of capital among affiliates must be adequately addressed in any group-wide capital framework for Board-supervised insurers. Given existing legal constraints on the transfer of funds between insurance subsidiaries (where the majority of insurers’ assets and liabilities reside) and their affiliates, there is no valid basis for holding capital at the holding company or in the “wrong” subsidiary in order to be a “source of strength” to insurance company subsidiaries. Capital mobility limits enshrined in state and foreign insurance laws ensure that the right amount of capital is held at operating insurance entities, and promote both policyholder protection and financial stability. Capital mobility limits also serve to contain any stress that might occur in one subsidiary and prevent contagion to other entities within the group. In short, capital is a resource and should not be presumed to be fungible. Any insurance group capital framework should be designed to recognize the limits on capital mobility across different parts of Board-supervised insurance groups.

Prudential strongly supports the Board’s efforts to develop regulatory group capital frameworks for Board-supervised insurers that are consistent with the Board’s supervisory objectives and appropriately tailored to the business of insurance. As we will describe in further detail, Prudential believes a single capital framework based on the BBA would best meet those objectives and should be applied to all Board-supervised insurers, both Insurance IDIs and Insurance SIFIs. We believe that a bifurcated approach introduces significant complexity in development, implementation, and ongoing maintenance of the two frameworks, and poses significant risk of unintended consequences.

The BBA is viable for all Board-supervised insurers.

Prudential believes the BBA is viable for all Board-supervised insurers and could, if constructed appropriately and employed in conjunction with other regulatory tools available to the Board, meet all of the Board’s supervisory objectives with respect to both Insurance IDIs and Insurance SIFIs.

Prudential believes that any group capital standard applicable to U.S. insurers should be based on existing insurance financial solvency regulatory regimes, and that this should be the case whether an insurer is an Insurance IDI or Insurance SIFI, and regardless of its size, business mix or complexity. Applying a completely different framework to the small number of Insurance SIFIs is not necessary and could create challenges to achieving the Board’s objectives. We believe that any differentiation for Insurance SIFIs is

more appropriately achieved through other regulatory tools as described below, and that such differentiation through the capital standard itself is inappropriate. Leveraging existing solvency regimes will ensure that any new capital requirement appropriately coheres and does not work at cross-purposes with the existing requirements applicable to entities within the group; reflects the unique nature of insurance entities and risks versus other financial institutions; leverages the existing conservative and well-tested regime of insurer financial regulation; and prevents application of potentially burdensome and inappropriate requirements to insurance entities.

Application of the BBA to all Board-supervised insurers would provide consistency and comparability in respect of capital regulation and, unlike the CA, the BBA could be implemented relatively easily in the short-to-medium term. Applying the CA to a small set of insurance groups (currently two) would, however, not advance the goal of comparability. Moreover, development of the CA would require significant time and resources and result in far more burdensome and disparate regulation for Insurance SIFIs than application of the BBA. Prudential is not aware of any financial sector (including banking) in which a small handful of firms is subject to an entirely different capital framework than other industry participants and competitors engaged in the same or similar lines of business. The design and construction from scratch of a completely new capital model and standards to measure risk and capital adequacy for Insurance SIFIs seems unnecessary and potentially counterproductive when a readily available, well-honed framework already exists.

A BBA based on the aggregation and calibration of legal entity capital according to existing jurisdictional rules, with appropriate definitions, adjustments and scaling, is thus viable for all Board-supervised insurers and would avoid the “crude risk segments” and “limited risk sensitivity” that the Board perceives as key weaknesses of the CA, weaknesses that could potentially result in inappropriate capital requirements and other unintended consequences, including misleading representations of insurance groups’ capital positions, disincentives to identify and reduce risks not captured under the capital rules, adverse impacts to insurance competition and markets, and inconsistencies between disparate frameworks. By leveraging existing and well-tested regimes specifically designed to measure the unique risks and nature of insurance activities (as well as Board capital rules designed for non-insurance subsidiaries), the BBA is capable of producing a well-defined, controlled, transparent, and expedient framework that would lend itself, in conjunction with continuing developments and refinements at the local jurisdictional levels, to ongoing monitoring and improvement. Finally, the BBA is capable of addressing several unique factors of insurance regulation (such as restraints on the fungibility of capital and the variety of local jurisdictional and product risks) that may be difficult or impossible for the CA to adequately address.

In appendix 1 to this letter, we further discuss why the BBA would be viable for all Board-supervised insurers and, on balance, better realize the Board’s objectives and goals. We do so by comparing the BBA’s features to the objectives and goals for an insurance capital framework and the strengths and weaknesses of the BBA and CA, each as identified by the Board in the ANPR.

The ANPR overstates the complexity of, and difficulties in applying the BBA to, Insurance SIFIs.

Prudential believes the reasons the Board gives for the BBA not being appropriate for Insurance SIFIs are not persuasive and do not reflect the true costs and benefits of the BBA and CA as applied to Insurance SIFIs. We believe that the Board overstates the degree and complexity of the factors by which it distinguishes Insurance SIFIs from Insurance IDIs,² and in any event it is not clear why the purported complexity, size, and scope of international and non-insurance operations of Insurance SIFIs could not be handled in a properly constructed BBA, why the BBA could not address such factors better than the CA, or whether the CA could even be properly designed to address them. Specifically:

² The ANPR differentiates Insurance SIFIs from Insurance IDIs as being “relatively larger financial institutions with substantial international operations, comparatively complex organizational structures relative to other insurance companies, and non-insurance as well as insurance activities.”

- *Size*: unlike in banking, size is a beneficial risk diversifier in insurance. Moreover, a larger amount of insurance assets and liabilities in a product line offered by an Insurance SIFI relative to the same product line offered by an Insurance IDI should by itself have no bearing on the type of risk segments and factors and general capital framework utilized to measure an insurer's capital adequacy.
- *Substantial international operations*: A significant majority of assets of the current Insurance SIFIs are located in the United States; the fact that an insurer has a material, but less significant, portion of its assets in non-U.S. operations should not by itself fundamentally alter the capital framework applied to it. For example, roughly two-thirds of Prudential's consolidated assets are in U.S. insurance operations, with the vast majority of the remainder in Japan. Application of the BBA, including through the use of scalars, could aggregate and calibrate legal entity capital rules for Prudential's U.S. and international operations without undue complexity.
- *Complex organizational structures*: Insurance SIFI complexity is not meaningfully greater than other insurers. Indeed, the "mutual" structure of certain Insurance IDIs, and the fact that they all by definition own banking subsidiaries, arguably presents equivalent if not greater organizational complexity. It is not clear what the Board perceives as "comparatively complex" in respect of Insurance SIFIs. The organizational structure of an insurance group is generally driven by the relative separation of different activities by type and jurisdiction into different legal entities, which is in part a function of the state based regulatory system, and in Prudential's view does not denote complexity. This type of legal structure actually reduces complexity in many respects, both in terms of risk measurement for each legal entity and in terms of preventing the spread of distress from one entity to another. This unique feature of insurance groups makes it crucially important for the right amount of capital to be held in the right entity rather than for extra capital to be held elsewhere. In any event, the BBA is designed to address multiple subsidiaries through aggregation, calibration and appropriate adjustments.
- *Non-insurance operations*: The non-insurance operations of Insurance SIFIs are not, at least currently, material, when considered in terms of the development of a capital standard to be applied to entities predominantly engaged in insurance (and for structural and regulatory reasons, it is unlikely this will change). Accordingly, this would not appear to be a valid basis by which to distinguish Insurance SIFIs and Insurance IDIs (which, after all, do engage in non-insurance, banking operations). For example, the only material non-insurance operation of Prudential is its asset management business, an activity the Financial Stability Oversight Council ("FSOC") has not determined to be systemic and has suggested can be regulated through an activities-based approach. Even were an Insurance SIFI to engage in more material or risky non-insurance operations, the BBA is designed to apply the appropriate jurisdictional rules to non-insurance subsidiaries through the capital rules set forth in the Board's Regulation Q (including for banking entities owned by Insurance IDIs). It would seem likely that the relevant risk weights and factors that would be applied to non-insurance activities under the CA would also, at some level, be drawn from the Board's Regulation Q. In this respect, both the BBA and CA would be able to adequately measure risks in, and ensure there is appropriate capital for, non-insurance activities conducted in unregulated subsidiaries.

In sum, the BBA can accommodate insurance groups of any size, organizational structure and global footprint, as well as the non-insurance activities and entities within a group. This can be accomplished through a set of guiding principles and specific applications of those principles to identify appropriate regimes for all entities and to apply appropriate adjustments and scaling to support the aggregation of capital at the group level.

Other regulatory tools are available to adequately address any differences in risk or complexity between Insurance SIFIs and Insurance IDIs.

The systemic risk, if any, that the Board perceives may differentiate Insurance SIFIs from Insurance IDIs can be adequately addressed through capital stress testing, liquidity risk management standards, including liquidity stress testing, and other enhanced prudential standards that the Board is authorized or required to implement for Insurance SIFIs.

Annual supervisory capital stress testing will enable the Board to monitor and refine the application of the BBA to Insurance SIFIs to ensure that any systemic risks are adequately addressed at the capital level. Prudential believes that the BBA would serve as a good basis for capital stress testing. The BBA can be stress tested using the Board's macroeconomic stress scenarios and an explicit insurance stress charge which could be anchored in the insurance stresses and factors already used for stress testing under state insurance statutory regimes.³ Instead of developing and applying a new and distinct capital regime to the small number of Insurance SIFIs, stress testing (in addition to liquidity risk management standards, including liquidity stress testing)⁴ can be applied as an additional tool and differentiating mechanism for the prudential regulation of Insurance SIFIs, without losing the benefits that a single BBA-based capital regime applied to all Board-supervised insurers would bring.

The central foundation on which the FSOC has premised its decisions to designate Insurance SIFIs relates to the FSOC's concern that material financial distress at an insurer could hypothetically trigger a "run" on insurance products that permit early surrender or withdrawal, leading to short-term liquidity needs and potential fire sales of assets that could pose systemic risk. This premise has been questioned by firms designated as Insurance SIFIs, by dissenting members of FSOC and by other commentators, and Prudential continues to believe the premise is unfounded and that substantial, regulatory, contractual, practical and economic factors make this "run" hypothesis untenable. Notwithstanding these reservations, the FSOC's perception of supposed "run" risk, which underpins its determination of systemic risk at Insurance SIFIs, would best be captured through liquidity risk management standards, including liquidity stress testing, as opposed to more stringent capital requirements.

The Board notes that the CA would initially involve crude risk segments and limited risk sensitivity, but that it could evolve over time to have an increasingly granular segmentation approach with greater risk sensitivity. However, use of the BBA, which would leverage already granular and risk sensitive factors (and model-based approaches as appropriate⁵) that have evolved over decades of supervisory oversight by state and other jurisdictional insurance regulators and have been tested through time, including times of stress, would provide these benefits more quickly and in a manner that would allow the Board to compare capital adequacy across a far larger set of insurance groups. Stress testing would, in addition, provide the Board an additional tool to understand, test and refine the application of BBA to Insurance SIFIs. The application of a cruder factor-based capital framework to Insurance SIFIs could, however, create unintended consequences and pose challenges for conducting reliable stress tests due to the overall untested nature of the risk segments and factors. At the very least, significant development and field-testing would be necessary in order to ensure that the CA would be compatible with any stress testing framework imposed by the Board.

³ For instance, the "C2" life insurance risk charge in the NAIC's RBC framework can serve as the insurance stress charge applied on top of the macroeconomic stress scenarios in stress testing the BBA.

⁴ Proposed liquidity risk management and stress testing requirements are the subject of a separate notice of rulemaking issued by the Board. Prudential submitted comments on this proposal on August 17, 2016.

⁵ For instance, we refer you to "C3" Phase II RBC for variable annuities and the emerging model-based approaches for catastrophe risk in property-casualty lines.

Any development of the CA should proceed with great care.

If the Board chooses to follow its proposed bifurcated approach, Prudential does not believe size would be a logical distinction to base application of the CA over the BBA, since size is not indicative of systemic risk in the business of insurance but rather provides diversification, a fundamental element of the insurance business model. Although designation as an Insurance SIFI may appear logical as a differentiator, the “systemic” nature of firms that have been designated as SIFIs remains contested and problematic. Prudential continues to believe that it does not, and could not, pose systemic risk to the U.S. economy and financial stability. Moreover, considering current legal challenges to, and continuing refinements of, the SIFI designation process, and that its future scope remains somewhat uncertain (*e.g.*, the FSOC is advocating a different, activities-based approach for asset managers), using SIFI designation as the basis for application of the CA may be premature, or at least merits further consideration.

Prudential has provided, in the third section of this comment letter, comments and suggestions on the design of the CA, as it is essential if the Board determines to pursue development of the CA that it be designed in a manner that is appropriately tailored to the business of insurance. Although construction of a BBA could likely be done relatively quickly, it will take time to construct a CA capital regime from scratch. Prudential believes it is paramount that the Board take the necessary time to design, field test, and refine the CA before it is applied to Insurance SIFIs.⁶ We believe it is crucial that the Board conduct a quantitative impact study (“QIS”) and field testing of any proposed CA prior to applying it as a capital requirement for Insurance SIFIs. This will inform the Board on the extent to which the CA adequately measures insurance risks and capital requirements, and where it needs refinement, and will provide the Board with granular and relevant information on the business and operations of insurance companies, a sector the Board has not historically supervised.

In light of the crude risk segments and limited risk sensitivity the Board notes the CA would initially exhibit, and the risk of unintended consequences that could arise therefrom (especially in the absence of prior field testing and refinement), Prudential recommends, in the event the Board determines to pursue the application of the CA to Insurance SIFIs, that the Board initially apply the BBA to Insurance SIFIs until such time as the CA has been sufficiently refined and field tested. This would afford the Board the opportunity to see how the BBA is applied to Insurance SIFIs, in conjunction with stress testing and as compared to its application to Insurance IDIs, and concurrently with its field testing and refinement of the CA, enabling the Board to compare outcomes under both approaches and providing it with a sound basis on which to make a determination as to the ultimate approach to be applied to Insurance SIFIs.

Determining applicability of capital rules tailored to the business of insurance.

All Board-supervised institutions should be subject to the same criteria for determining whether the institution is subject to regulatory capital rules that are tailored to the business of insurance. A standard of 25% of an organization’s total consolidated assets attributable to the underwriting of insurance would be appropriate, as this is consistent, as the Board has noted, with a 25% threshold used in other similar regulatory contexts. In determining whether a supervised institution’s operations represent insurance activities, the most important factor to consider is the degree to which the business activities fall under the regulatory oversight of an insurance supervisory authority. These activities include but are not limited to: insurance underwriting

⁶ The design and refinement of the Solvency II framework lasted over 10 years, following multiple consultations and many years of field-testing and refinement. Likewise, the development of the IAIS’ International Capital Standard has been underway since 2013 and is projected to continue development beyond 2019, with implementation conditional on multiple consultations, evolving versions (version 1.0, 2.0 and perhaps more), field-testing and confidential reporting. Finally, the process of designing the various Basel bank capital regimes, and the Board’s implementation of them as applicable in the United States, has elapsed over several decades, and in some respects continues, even though the capital frameworks were already in development at the international level and related to an industry the Board has historically supervised.

and risk assumption; insurance policy and contract development, marketing, distribution and issuance; reinsurance; insurance-related investment activities; and general policy administration, including policyholder payment, claims management and related operational services.

B. Comments on the design of the Building Block Approach

Introduction and overview – Prudential Strongly Supports the BBA.

As discussed above, we believe the Board’s proposed BBA is the most appropriate methodology for creating a group capital regime for companies predominantly engaged in insurance. The BBA provides a foundation for objective capital evaluation for Board-supervised institutions that are significantly engaged in insurance activities. The use of existing regimes allows the Board to achieve its supervisory objectives efficiently and effectively by leveraging existing capital frameworks that have proven to be robust throughout time, including during periods of stress. Many of these existing regulatory capital regimes are mature and continue to evolve as markets, products, and consumer needs change.

The concepts put forth in the ANPR with respect to the BBA are well-aligned with industry views on an insurance-appropriate group capital construct, developed by a broad coalition of life and property and casualty insurance companies, including Prudential. Leveraging those views, our response summarizes the key requirements and principles which we believe are satisfied by the BBA, and responds to questions posed in the ANPR by providing recommendations that we believe will enhance or clarify specific design elements of the BBA.

We agree with the Board that under an aggregation approach which leverages existing capital regimes, adjustments are necessary to ensure proper treatment of organizational structures, intercompany transactions, and other aspects and activities of the group. As discussed in greater detail below, Prudential supports a set of proposed adjustments that can be used in the BBA to ensure an appropriate aggregation-based group solvency measure that is transparent and comparable across Board-supervised insurers. We also agree with the Board that calibrating and “scaling” or “equating” jurisdictional capital standards in a stable, repeatable manner is necessary for an aggregation-based approach, as existing regimes have similar but distinct methodologies for evaluating risk in accordance with local supervisory objectives. Thoughtful scalar calibration is necessary to ensure a meaningful group capital framework that avoids mismeasurement or the creation of capital arbitrage opportunities. Our response includes suggestions for the use of scalars, including principles and methods for the development and application of scalars in the BBA.

In the following responses to questions posed in the ANPR, we offer recommendations on key considerations that may be useful in designing the BBA.

Part 1. Key Requirements of the BBA

We believe that the BBA satisfies key requirements that should apply to an insurance-appropriate group capital framework. Below we summarize our views on these key requirements and how these are met by the BBA. We note that these requirements also align with the Board’s objectives.

The BBA meets key requirements for an insurance appropriate group capital framework	
<i>Capital Framework Requirement</i>	<i>How the BBA Addresses the Requirement</i>
Tailored to the business of insurance	<ul style="list-style-type: none"> • Leverages existing risk sensitive frameworks designed specifically for insurance organizations • Utilizes proven, well-understood, continually evolving standards to reflect changes in markets and products

	<ul style="list-style-type: none"> • Leverages, to the extent possible, an insurer's existing policies and systems for capital management
Establishes a near ready-to-implement framework	<ul style="list-style-type: none"> • Because the BBA is grounded in the use of existing, robust and mature capital regimes, implementation should be reasonably quick with less resource intensity than a newly-created alternative standard. New processes will be limited to the identification and quantification of certain adjustments and the development of calibration and scaling mechanisms as described herein.
Promotes prudent risk management	<ul style="list-style-type: none"> • Consistent with and additive to regulatory solvency rules
Comparable across insurance firms and jurisdictions	<ul style="list-style-type: none"> • Calibration allows for comparison across jurisdictions and institutions • Maintains comparability across companies within a common jurisdiction, eliminating the potential for market distortions by subjecting companies to different standards • Allows for comparison of companies within an industry with varying geographic, product, consumer, or other characteristics
Reflects differences between various insurance, bank and unregulated activities, including life and non-life	<ul style="list-style-type: none"> • Reflects differentiated treatment in existing solvency regimes applicable to insurance, bank and unregulated entities and activities
Captures risks associated with non-insurance and unregulated activities, including for the holding company	<ul style="list-style-type: none"> • Considers all entities, and aggregates and calibrates capital measures across existing solvency frameworks (insurance and non-insurance)
Can work for multiple accounting regimes (SAP, GAAP, other)	<ul style="list-style-type: none"> • Can work for entities that use SAP, GAAP or other accounting regimes (including insurance groups that are only required to file SAP financial statements) • For entities with no formal capital regulation, an appropriate accounting and capital regime can be specified
Subjects the insurance group to an aggregated group solvency ratio	<ul style="list-style-type: none"> • Provides a group-wide framework that defines and calculates a group-wide capital ratio

Additionally, the BBA has the benefit of being anchored in existing audited accounting and capital regimes, which would comprise the vast majority of the calculations for this framework. Moreover, unlike the CA, the BBA will allow the Board to ascertain the capital position of each of an insurance group's major business entities. As noted above, the BBA can also be utilized as a foundation for stress testing. The potential weaknesses of the BBA that are raised in the ANPR can be successfully mitigated through appropriate scaling and adjustments, described below.

Part 2. Specific Responses and Recommendations regarding the Proposed BBA Framework

This Part 2 provides specific responses and recommendations on the elements of the BBA, along with a supporting rationale for each response and recommendation. This Part 2 is organized in sub-sections grouped by the following topics:

- A. Overall framework
- B. Available capital / qualifying capital
- C. Required capital and baseline capital
- D. BBA adjustments
- E. Scalars
- F. Minimum capital requirement
- G. Application of the BBA to Insurance SIFIs

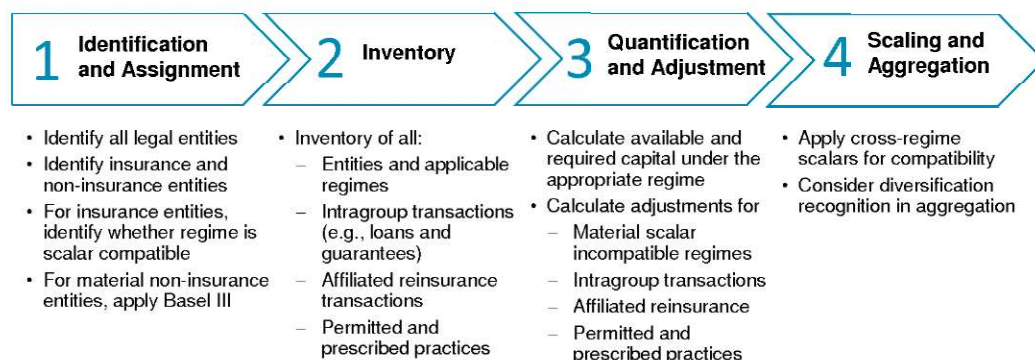
A. Overall framework.

In this sub-section, we provide our feedback on the overall BBA capital framework that is proposed in the ANPR. We support the overall approach of aggregating information from local capital regimes. We suggest that the BBA framework be guided by a set of overarching principles to ensure appropriate design, as well as comparability and consistency.

The use of guiding principles will help to ensure appropriate definitions and applications within the BBA, for instance with respect to the assignment of appropriate capital regimes for each entity within a group, adjustments for intercompany transactions, and scaling of regimes to a consistent level of stringency. We believe that five key guiding principles should apply to the BBA. These are summarized below.

Key principles should guide the design of a BBA	
Reflect appropriate regime: insurance vs. non-insurance	<ul style="list-style-type: none"> • All entities differentiated between insurance and non-insurance • Insurance entities treated under existing solvency regime • Non-insurance entities, if material, treated under the Board's implementation, under its Regulation Q, of Basel III (henceforth referred to as "<u>Basel III</u>") or other applicable capital rules
Minimal adjustments to existing regimes	<ul style="list-style-type: none"> • Existing solvency measures should be preserved where appropriate • Apply regime at highest level of existing consolidation where appropriate
Indifferent to corporate structure	<ul style="list-style-type: none"> • The location of an entity within the group structure should not impact capital at the aggregated level • Intra-group transactions should not impact capital at the aggregated level
Comparable across regimes	<ul style="list-style-type: none"> • The group-level aggregation must reflect comparable levels of risk, achieved through scaling of capital measures across regimes
Transparency	<ul style="list-style-type: none"> • Inventory of all entities, including their regulatory regime • Inventory of intra-group transactions and related adjustments • Inventory of specific practices (<i>e.g.</i>, permitted and prescribed practices) and treatment within the framework

By adhering to these guiding principles in determining the appropriate applications of the BBA to supervised firms, the Board can ensure a comparable and consistent group capital framework. In terms of the structure of the BBA framework, we propose the following key steps: (1) identification and assignment; (2) inventory; (3) quantification and adjustment; and (4) scaling and aggregation. Below we describe these key steps and illustrate how they align to the five guiding principles.



Principles which guide the process

1 Reflects appropriate regime	✓		✓	✓
2 Minimal adjustments to existing regimes	✓		✓	
3 Indifferent to corporate structure		✓	✓	✓
4 Comparable across regimes	✓	✓	✓	✓
5 Transparent	✓	✓	✓	✓

These steps and principles align in many ways to the high-level concepts proposed in the ANPR with respect to the BBA. However, we believe that a key aspect of the BBA framework as proposed in the ANPR requires modification in order to ensure appropriateness, comparability and consistency.

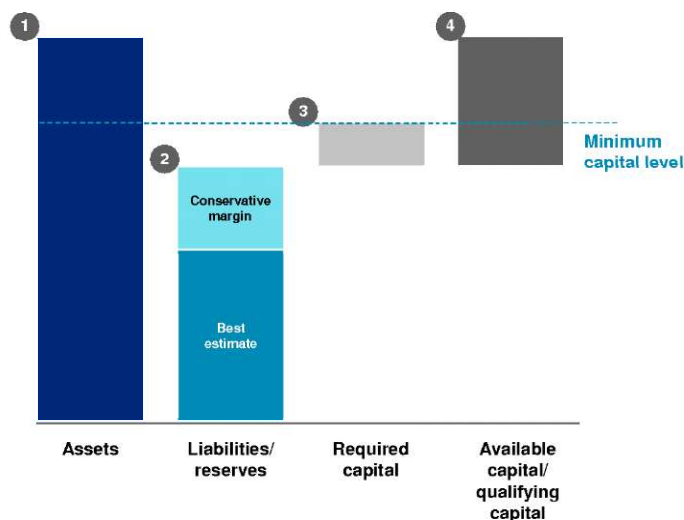
The Board proposes a BBA capital framework that sums (or uses consolidated) local available capital, and that scales and aggregates local required capital:

$$BBA \text{ capital ratio} = \frac{\text{Sum of Qualifying Capital Resources}}{\text{Sum of (Required Capital x Scalars)}}$$

In addition, the Board proposes a set of adjustments to promote comparability and consistency, and to avoid double-counting.

While we support a scalar-based approach to aggregate balance sheet information across regimes and jurisdictions, we are concerned that the Board's proposed approach of scaling only required capital would not appropriately capture differences in the level of conservatism in reserves across regimes, which is a key source of difference across jurisdictional accounting and capital regimes and a necessary element to recognize in a framework that aggregates capital across different regimes. To address this, and to align with the "comparable across regimes" guiding principle for the BBA, we propose a "total balance sheet approach" that applies scalars to both available capital and required capital. Scaling both available and required capital enables the BBA to appropriately capture the following key drivers of difference across regimes: asset valuation and admissibility standards; conservatism in reserves; calibration of required capital; and the definition of qualifying capital. These elements and their relationship in the context of insurance company capital are illustrated below:

Illustration of capital for a typical solvency regime



Key differences across regimes

- 1 Asset valuation and admissibility standards
- 2 Level of conservatism in reserves
- 3 Require capital calibration
- 4 Definition of qualifying capital

In the remaining sub-sections, we discuss specific recommendations for the design and application of a BBA framework, aligned to the five key guiding principles. In particular, we offer recommended approaches to scalars and adjustments that, in totality, consider and capture all of the major sources of difference across regulatory capital standards and ensure a meaningful and appropriate group capital ratio on the basis of aggregation of legal entity available and required capital.

B. The approach to available capital and the definition of qualifying capital.

In this sub-section, we address the Board's request for feedback on how to determine the available capital of an insurance group and whether a uniform definition of qualifying capital should be adopted. Our suggested method is to aggregate available capital at each legal entity, adjusting for other factors, such as qualifying capital, in the calibration and application of cross-regime scalars. This simple approach recognizes the interdependency in each solvency framework of asset and liability valuation, required capital and capital eligibility, as well as the requirement that certain industry participants (e.g., mutual insurers) not be required to produce a consolidated GAAP balance sheet.

The ANPR discusses two potential approaches to measure available capital: (1) apply a common definition of available capital on a fully consolidated basis, in a consolidated balance sheet; or (2) sum available capital for each legal entity, according to the local regime.

We believe that the first approach, applying a common definition of available capital on a fully consolidated basis, is not practical or necessary for the BBA. This approach suggests the need for a consolidated balance sheet. However, as recognized by the ANPR, the Board is restricted in its ability to mandate consolidated GAAP financials to those organizations that are required to prepare only legal entity level statutory financials. Prudential believes that the second approach, the summation of available capital, is the appropriate approach for the BBA. We note, however, this approach also requires the application of adjustments and scalars in order to ensure alignment with the required capital component of the BBA and account for the items that generate differences between capital regimes, such as reserve conservatism, asset admissibility, and different definitions of qualifying capital instruments. As such, we recommend an approach that scales and aggregates both local available and required capital, and would enable holistic capture of these factors. We discuss this approach in greater detail later in our response (*see* Part 2E, regarding scalars).

C. The approach to required capital and baseline capital.

In this sub-section, we address the Board’s request for feedback on how to aggregate required capital of the insurance group, and how to set the baseline capital requirements for each local regulatory regime. In addition to scaling available capital, our suggested method is to adjust, scale and aggregate required capital of each legal entity, as needed, to ensure an “apples-to-apples” aggregation. We propose that the baseline capital level should be set to comparable regulatory intervention levels of each regulatory regime (e.g., 100 percent of Company Action Level RBC). While our proposed approach is generally consistent with that described in the ANPR, we have several specific recommendations regarding the application of the scalars, the identification and treatment of scalar compatible versus scalar incompatible regimes, and the identification of applicable regimes for holding companies.

In the ANPR, the Board proposes to determine group-level required capital by scaling and aggregating the required capital of each legal entity of the group, where the starting point for each legal entity is the local capital requirement, if one exists, and otherwise defaults to the Basel III standardized approach.

We support the Board’s general approach to scale and aggregate local capital requirements, with the following recommendations:

1. Scalars, rather than just being applied to required capital, should also be applied to available capital.
2. The BBA should distinguish between “scalar compatible” versus “scalar incompatible” regimes.
3. The BBA should recognize diversification benefits across geographies and business segments – for example, life insurance vs. property and casualty insurance vs. banking.
4. Rather than defaulting to Basel III, a holding company should use the capital regime applicable to its primary subsidiary or subsidiaries.

We summarize our rationale for these recommendations in the below table:

ANPR proposal	Recommendation / proposed changes	Rationale
1 Scalars should be applied to required capital only	Scalars should be applied to both available and required capital (<i>see</i> Part 2E regarding scalars for more detail).	The ANPR scalar approach fails to take into account differences in conservatism in reserves between regimes.
2 All local insurance regimes qualify for use in BBA	<p>The BBA should distinguish between “scalar compatible” and “scalar incompatible” regimes.</p> <p>For scalar compatible regimes, local capital measures can be scaled and aggregated in BBA.</p> <p>For scalar incompatible regimes:</p> <ul style="list-style-type: none"> • If the entity has significant recourse to the group (<i>e.g.</i>, affiliate guarantees provided to an entity), then the entity should be restated to a scalar compatible regime. The regime of choice should minimize burden of restatement on the insurer, such as leveraging existing accounting where possible. • Otherwise, a simple but conservative risk factor (50 percent) can be applied to the carrying value. Fifty percent is equivalent to the risk charge for an affiliate 	<p>Some regimes may not be appropriate for scaling and aggregating within the BBA.</p> <p>For example, some regimes may not support a robust calibration of cross-regime scalars, because they may fail to satisfy the following requirements:</p> <ul style="list-style-type: none"> • A risk-sensitive regime to differentiate between insurers. • Meaningful and clear regulatory triggers as the common evaluation basis of

ANPR proposal	Recommendation / proposed changes	Rationale
	<p>insurance entity under US property-casualty insurance RBC.</p> <p>Figure 1 in appendix 2 provides an illustration of the above.</p> <p>The Board can identify scalar compatible regimes by leveraging existing third-party evaluations of insurance solvency regimes, including:</p> <ul style="list-style-type: none"> • International Monetary Fund (IMF) Financial Sector Assessment Program (FSAP) determinations • Solvency II equivalence (for solvency) determinations by the European Commission⁷ • The NAIC Qualified Jurisdiction List⁸ <p>Regimes outside of these lists should be considered scalar incompatible. It is expected that the list of scalar incompatible regimes will grow shorter over time as global assessment of regimes continues and jurisdictional regimes themselves evolve.</p>	<p>an insurer's financial health and for comparison across regimes.</p> <ul style="list-style-type: none"> • Transparent and frequent reporting of capital measures.
3 Diversification benefit should be recognized across geographies and business segments	<p>The BBA should capture diversification of risks across legal entities of the group. Prudential recommends consideration of the following risk factors for diversification:</p> <ul style="list-style-type: none"> • Geography (<i>e.g.</i>, across continents) • Risk type/business segment (<i>e.g.</i>, across life insurance vs. property and casualty insurance vs. other non-insurance) <p>These factors can be implemented via a formulaic approach that is based on the pair-wise correlations of risk components, for example between life and property and casualty insurance.</p> <p>It is recommended to include risk diversification only <i>across</i> entities, given that intra-entity diversification is already considered via existing entity-based regimes.</p>	<p>An effective risk aggregation approach should recognize risk diversification that aligns with underlying economic risks, thereby improving the ability of the BBA to measure solvency and promote prudent management (<i>e.g.</i>, providing incentives to pool less correlated risks).</p> <p>There are risk diversification factors across legal entities that are not yet accounted for, most prominently:</p> <ul style="list-style-type: none"> • Insurance-related stresses (<i>e.g.</i>, catastrophe, mortality) vs. financial risks • Catastrophe risks across major geographical divides
4 Holding companies should use	For holding companies (which for insurance groups generally conduct no business and have very limited operations), apply the most representative regime, that	Assigns the appropriate standard by aligning with the regime that is applied to the activities and

⁷ <https://eiopa.europa.eu/external-relations/equivalence>; http://ec.europa.eu/finance/insurance/solvency/international/index_en.htm

⁸ http://www.naic.org/documents/committees_e_reinsurance_qualified_jurisdictions_list.pdf

ANPR proposal	Recommendation / proposed changes	Rationale
Basel III as capital regime ⁹	is, the regulatory regime that supervises the largest proportion of the holding company's subsidiary assets. Alternative metrics for holding company assets not generally held by such primary subsidiaries can be used as appropriate.	assets of the holding company's primary subsidiaries.

The Board has not specified the baseline capital requirement (the starting measure of local required capital that would be adjusted, scaled and aggregated) under the BBA. We believe that it is appropriate to set this to the comparable regulatory intervention levels of each regulatory regime. For U.S. insurers, 100 percent of Company Action Level (“CAL”) RBC is an appropriate baseline. Under U.S. insurance law and regulation, an insurance company that breaches this level must file a corrective action plan. Equivalent regulatory trigger points can be used as the baseline capital levels for other regimes. These baseline capital levels would then be adjusted and scaled as necessary to ensure comparability for aggregation.

D. BBA adjustments needed to ensure comparability and consistency across insurance regimes.

In this sub-section, we address the Board's request for feedback on what “adjustments are appropriate to implement the BBA, and make the BBA effective in helping to ensure resiliency of the firm and comparability among firms, while minimizing regulatory burden and incentives and opportunity to evade the requirements” (question 8). We propose a set of adjustments that aligns with the Board's requirements. These adjustments can evolve over time and should be complemented with a comprehensive inventory that provides the Board with transparency into the insurance group and into specific BBA calculations.

As discussed in the ANPR, the BBA would require the use of several types of adjustments in the calculation of a firm's enterprise-wide capital requirement. The key purpose of these adjustments is consistent with the key principles of promoting:

- Comprehensive coverage of risks, while avoiding any double-counting.
- Consistency and comparability of capital treatment across and within regimes to mitigate capital arbitrage.

These principles and requirements align with the Board's stated goals in the ANPR of conforming or standardizing accounting practices under Statutory Accounting Principles (“SAP”) among U.S. jurisdictions, and between SAP and foreign jurisdictions, as well as to eliminate the impact of inter-company transactions. We recommend a set of specific adjustments as a starting point for BBA. The Board can refine and supplement these adjustments as appropriate over time. We review our recommended initial list of adjustments and the rationale for each below:

Topic	Description of issue and rationale for adjustment	Proposed adjustment
1 Life captive and non-captive business –	The use of captives for U.S. term life and ULSG business results in inconsistent reserving and capital standards across life insurance entities.	All term life and ULSG business written in the U.S., regardless of captive vs. non-captive status, should follow the same reserving and capital rules.

⁹ For holding companies that are not insurance operating companies.

Topic	Description of issue and rationale for adjustment	Proposed adjustment
term and universal life with secondary guarantees (“ <u>ULSG</u> ”)	<p>The NAIC Principle-Based Reserving (“<u>PBR</u>”) standard is expected to replace the current term life/<u>ULSG</u> standards, which will eliminate the incentive to use captives going forward, but this standard will “grandfather in” existing captive treatment, and hence existing inconsistencies, and will only apply to new business.</p>	<p>We propose to adopt the forward-looking PBR standard for reserving and NAIC RBC Model Law and SAP rules for capital requirements (<i>e.g.</i> asset admissibility rules and RBC standard), for all term life and <u>ULSG</u> business.</p> <p>We also recommend allowing life insurers to use the more conservative XXX/XXXX reserves in lieu of PBR reserves in cases where the PBR restatement impact is small but operationally burdensome. However, in all cases the insurer must follow the SAP rules for asset admissibility and NAIC RBC Model Law for required capital.</p> <p>See <i>Figure 2</i> in appendix 2 for an illustrative example.</p>
2 Variable annuity (“ <u>VA</u> ”) captive and non-captive business	<p>The current U.S. statutory regime for guaranteed variable annuities employs an approach that does not produce a clear distinction between reserves and required capital</p> <ul style="list-style-type: none"> • Approach dictates a Total Asset Requirement (“<u>TAR</u>”) – <i>i.e.</i>, the minimum amount of assets to support the portfolio • While the statutory framework prescribes a separate set of calculations for reserves, the spirit of the guideline is TAR-based • Required capital is calculated indirectly as the amount of total required assets in excess of reserves <p>The lack of a stable distinction between reserves and required capital drives volatility in the RBC ratio that is not aligned with actual risk and leads many major VA writers to employ voluntary reserves. This practice distorts the comparability of RBC ratios across insurers.</p>	<p>We recommend adopting the new NAIC VA standard for reserves and capital, once it is implemented.</p> <p>As an interim placeholder, we recommend a simple adjustment to VA reserves and capital by:</p> <ul style="list-style-type: none"> • Retaining the existing TAR requirement (C3 Phase 2) • Stabilizing the distinction between reserves and required capital by assigning a fixed percentage of TAR to reserves and the remaining to required capital <p>See <i>Figure 3</i> in appendix 2 for an illustrative example.</p>
3 Other captives and affiliated reinsurance	<p>Insurers may utilize other approved captives and affiliated reinsurance in order to better reflect the underlying risks and economics of their business.</p>	<p>No specific adjustment proposed, given that:</p> <ul style="list-style-type: none"> • Other uses of captives generally do not

Topic	Description of issue and rationale for adjustment	Proposed adjustment
		<p>result in changes to reserves/capital (<i>e.g.</i>, property and casualty risk pools that pool and diversify risks)</p> <ul style="list-style-type: none"> • Affiliated reinsurance to scalar compatible regimes would be calibrated via prescribed adjustments and scalars • Affiliated reinsurance to non-scalar compatible regimes would be restated or have a punitive risk charge assigned • Additionally, any such transaction could be reviewed by the Board via the BBA inventory (discussed below)
4	<p>New York-domiciled insurance entities</p> <p>New York State (“NYS”) reserving standards, on balance, are more stringent than NAIC-prescribed standards, thus reducing comparability.</p>	<p>Available and required capital should be restated based on NAIC Model Law standards. Differences between NYS and NAIC Model Law are often reported in Footnote 1 of the statutory financial statements.</p> <p>Companies that do not restate financials may opt out of the adjustment.</p>
5	<p>Intragroup transactions (excluding affiliated reinsurance)</p> <p>In addition to affiliated reinsurance, there are three major types of intragroup transactions that could distort group capital results:</p> <ol style="list-style-type: none"> 1. <i>Investments in affiliates</i> (including surplus notes) may lead to double-counting of available and required capital (<i>e.g.</i>, double leverage) 2. <i>Intragroup guarantees</i> may create required capital without economic substance on a consolidated basis 3. <i>Intercompany loans</i> may create redundant required capital (like for guarantees), and may also alter group available capital as a result of deviations in loan asset/liability valuation of the two affiliate entities 	<p>Adjustments to intragroup transactions should eliminate the impact of these transactions on group capital. In line with this objective, our recommendation is to:</p> <ol style="list-style-type: none"> 1. Exclude the impact of investment in affiliates from available and required capital (<i>i.e.</i>, ensuring all capital and risks are comprehensively captured but not double-counted) 2. Eliminate/exclude any risk charge associated with parental guarantees (unless they can be otherwise linked to third parties) 3. Eliminate/exclude any risk charge associated with affiliate loans, and adjust group available capital for any material differences in loan asset/liability carrying value <p>See Figures 5 and 6 in appendix 2 for illustrative examples.</p>
6	<p>Permitted and prescribed practices</p> <p>Permitted and prescribed practices may vary by state and entity that can lead to non-uniform capital measures that deviate from statutory or NAIC standards.</p>	<p>In addition to any permitted and prescribed practices related to items 1-5 above, an inventory of permitted and prescribed practices should be taken but no specific adjustment should be made, unless</p>

Topic	Description of issue and rationale for adjustment	Proposed adjustment
		<p>determined necessary via <i>ad hoc</i> review, given that:</p> <ul style="list-style-type: none"> • The vast majority of permitted and prescribed practices are related to captives and NYS entities that are already adjusted for; and • The remaining practices generally have valid economic grounding that should be preserved

In addition, we recommend that the Board require insurers to develop a detailed inventory that catalogs all the key aspects of the insurance group and key elements, such as adjustments, of its BBA calculation. This inventory would provide full transparency into the insurance group and the inner workings of its BBA calculation to the Board.

We propose an inventory that captures the following information:

- *List of legal entities of the insurance group*: the insurer can leverage existing NAIC Schedule Y or other standards that already identify all legal entities.
 - This should also include a brief description of the entities, and identification and rationale for the applicable solvency regime.
- *List of material affiliate holdings and transactions* (netted between entities, where applicable), including identification of involved entities, nature and size of transaction. These transactions include:
 - Affiliated reinsurance transactions
 - Intercompany loans
 - Intercompany guarantees
 - Affiliate surplus notes
- *List of permitted and prescribed practices*: include all that differ from NAIC SAP/RBC, including identification of the relevant entity, description and rationale of the practice, and its impact to capital, if any.

E. Scalars needed to ensure comparability and consistency across insurance regimes.

In this sub-section, we address the Board's request for feedback on what "scalars are appropriate to implement the BBA" (question 8). We propose a scalar approach that differs from the ANPR approach to scalars. Instead of scaling required capital only, we strongly recommend scaling both available and required capital in order to capture the differences in asset and reserve valuation, and to better align with the definitions of required and qualifying capital. We recommend calibrating the scalars according to two observable points of each regime: i) the regulatory triggers (e.g., CAL RBC); and ii) the average operating ratio, for insurance groups of similar size and financial health. Our approach enables the Board to adopt a simple framework that holistically captures "total balance sheet" differences between regimes, and to calibrate scalars objectively using robust, observable data.

In the ANPR, the Board proposes to scale required capital only. However, as discussed above, this simplified approach fails to account for differences in accounting conservatism of reserves. Therefore, we urge the Board to develop a BBA using a “total balance sheet approach” that applies scalars to *both* available and required capital.

To determine the scalar values, the BBA should follow a total balance sheet-based calibration approach that draws upon regulatory triggers (levels of regulatory intervention) and average operating ratios for companies operating in the same regime at a similar level of financial strength.

The objective of the scalars is to equate each regime at two points of calibration – the regulatory trigger level and the average operating ratio. Calibrating to the regulatory trigger is appropriate because regulators are expected to intervene at similar levels of capitalization or financial health under robust regimes. Additionally, insurers of similar size, business mix and financial strength rating in distinct but robust regimes should be comparable, and hence comparison of their operating capital ratios is also appropriate.

As an illustrative example, if the two calibration points are 100 percent and 500 percent for regime A, and 200 percent and 800 percent for regime B, then the scalars are developed so that 100 percent for A is equivalent to 200 percent for B, and 500 percent for A is equivalent to 800 percent for B.

The steps in determining an appropriate scalar are:

1. For each regime, identify the capital trigger at which regulators mandate similar actions.
 - Assumes regulators have similar total balance sheet requirements at the regulatory trigger
 - We recommend the level at which companies must file a corrective action plan (*e.g.*, CAL for RBC), as an appropriate calibration/trigger point
2. Measure average capital ratios for similar companies under each regime.
 - Assumes similar companies hold similar levels of assets relative to their total balance sheet requirement (*i.e.*, liabilities plus required capital)
 - Companies should be grouped based on financial strength ratings or other easily applied metrics (*e.g.*, total assets, total revenue)
3. Calculate the ratio of excess capital to required capital for each regime (where excess capital is defined as available capital in excess of the regulatory trigger) and compare them to determine the scalars.
 - See below for an illustration of the scalar calibration and application:

RBC/Regime X scalar calibration (illustrative)

	US RBC	Regime X
Regulatory trigger ¹	100%	100%
Average capital ratio in jurisdiction ²	518%	191%
$\text{Excess ratio} = \frac{\text{Avg capital ratio} - \text{Regulatory trigger}}{\text{Regulatory trigger}}$		
▼		
Excess capital ratio	418%	91%
$\text{Regime scalar} = \frac{\text{Regime X excess capital ratio}}{\text{RBC excess capital ratio}}$		
▼		
RBC/Regime X scalar	0.22x	

1. Represents the capital ratio at which companies must file with the regulators a plan for corrective action.

2. For simplicity of this stylized example, represents the average capital ratio of all life insurance companies in the respective jurisdictions. Alternatively and in future applications, these companies can be identified either through credit/financial strength ratings or via other metrics – e.g., total assets, total revenue – in combination with lines of business.

Scalar application to the Regime X insurance entity

1 Apply scalar to required capital (at trigger level)

Req. capital at regulatory trigger (100% for X)	\$1,000
× RBC/Regime X scalar	0.22
Required capital after scaling	\$220
Change in required capital relative to reg. trigger	(\$780)

2 Adjust available capital by the same dollar amount

Available capital before adjustment	\$2,000
+ Change in required capital relative to reg. trigger	(\$780)
Available capital after adjustment	\$1,220

In some instances, material differences between sectors within a regime—such as between life insurance and property and casualty insurance companies—will require separate scalars to adjust for differences in valuation, conservatism standards or required capital calibration. For example, in the U.S., life and property and casualty RBC have similar regulatory intervention levels but distinct operating capital ratios for companies with the same financial strength ratings. A separate calibration of scalars for life and property casualty RBC is appropriate and can be developed.

F. Definition of the minimum capital requirements.

In this sub-section, we address the Board's request for feedback on how to set the minimum capital requirement for the BBA. We recommend that the BBA anchor to the existing local intervention trigger for U.S. insurers (i.e., CAL RBC). This minimum level can evolve over time and be customized as needed, including for application to Insurance SIFIs.

In developing minimum capital ratios (i.e., the minimum threshold level), we believe that the Board should recognize existing local regulatory minimums and intervention levels as a starting point, especially if it is used as one of the scalar calibration points across regimes. Specifically, the RBC trigger points¹⁰ should be used as an initial anchor given the dominance of U.S. insurance assets and risks relative to other jurisdictions for Board-supervised insurers, including Insurance SIFIs. The CAL RBC would not need to be scaled if RBC is used as the initial calibration reference point and scalars are developed for other regimes relative to U.S. RBC.

The Board can modify this starting point minimum requirement (i.e., CAL RBC) as it gains experience and data through the QIS and implementation.

¹⁰ The RBC trigger points - Company Action Level and Authorized Control Level RBC – should be used as the initial anchor.

G. Application of the BBA to Insurance SIFIs.

As stated previously, we believe that the BBA is an appropriate standard applicable to all insurance groups, including Insurance SIFIs. This subsection discusses how the BBA can be adapted for Insurance SIFIs to reflect the Board's desire for greater supervisory rigor.

To satisfy the Board's desire for a supervisory regime for Insurance SIFIs that places additional emphasis on capital and liquidity planning and positions,¹¹ the Board may adapt and complement the BBA capital standard with liquidity and stress testing requirements for Insurance SIFIs.

The BBA can be successfully stress-tested by transparently testing individual material entities, and aggregating through the BBA framework. This approach allows the Board to develop a view of capital adequacy of each legal entity and of the group under stressed conditions that aligns with actual local regulatory solvency standards.

Part 3. Considerations for the implementation of the BBA framework

This Part 3 discusses specific questions posed in the ANPR and other considerations relating to the BBA that we believe are relevant and material, but not otherwise discussed in this letter. This Part 3 is organized in sub-sections grouped by the following topics:

- A. Scope and applicability of the BBA
- B. Compliance and effective date
- C. Strengths and weaknesses of the BBA, as discussed in the ANPR
- D. Other considerations for the BBA

A. Scope and applicability of the BBA

In this sub-section, we address certain of the Board's specific questions in the ANPR (Questions 11, 12 and 13), including the appropriateness of the BBA to larger and more complex insurance groups. As indicated above, Prudential believes the BBA is an appropriate framework for all insurance institutions, including Insurance SIFIs, regardless of size and complexity.

The BBA, implemented as a principles-based framework with appropriate scaling and adjustment, is able to accommodate institutions with diverse characteristics. The BBA framework can appropriately deliver a process for evaluating capitalization regardless of size, ownership interest, corporate structure, breadth of businesses, countries of operation, or other distinguishing attributes through a reasonable aggregation process including an appropriate scalar and adjustment process.

We believe it would be appropriate to apply the BBA to supervised institutions where 25% or more of the organization's total consolidated assets are attributable to the underwriting of insurance.

B. Compliance and Effective Date

In this sub-section, we address certain of the Board's specific questions in the ANPR (Questions 6 and 7), including the extent to which the BBA can leverage existing infrastructure and data, as well as the timeline and challenges in implementing the BBA.

¹¹ Per Governor Daniel Tarullo's speech on May 20, 2016; available at: <http://www.federalreserve.gov/newsevents/speech/tarullo20160520a.htm>

To the greatest extent possible, the BBA should seek to utilize existing records, data and systems. Regulated insurance and banking organizations have mature processes in place to meet requirements of existing capital regimes. Leveraging existing audited accounting and capital constructs, with limited adjustments applied, will speed implementation, minimize complexity and eliminate redundancy, and ensure a fit-for-purpose evaluation of risk.

Because the BBA leverages existing capital constructs, it could be implemented relatively quickly compared to alternative approaches. However, it will still take time to develop the various processes and controls related to *de novo* elements of the calculation (e.g., PBR adjustments for life captives). As a result, we recommend that the Board allow supervised insurers, at a minimum, 12 months before coming into compliance with any rules implementing the BBA.

While RBC is reported on an annual basis, we believe it would be feasible to migrate over time to quarterly reporting for purposes of reporting the BBA to the Board (which may include quarterly estimates).

C. Strengths and weaknesses of the BBA

In this sub-section, we recap and discuss the strengths and weaknesses of the BBA as discussed in the ANPR. We believe that most of the weaknesses indicated in the ANPR can be addressed by simple adjustments and scalars. In particular, we believe that the BBA's ability to stress test at the legal entity level is strength, and not a weakness. However, we also recognize that there are some implementation challenges that companies and the Board may be faced with, such as the effort required to develop robust scalars.

We summarize our views of the BBA's identified strengths and weaknesses below:

Strengths specified in ANPR	Prudential's Comments
1. Leverages local regulatory capital	We agree with the Board that these are important strengths of the BBA. That said, while the BBA can be implemented more expeditiously than alternatives proposed to date, there are still significant components that will require Board development, such as the development of scalars, and areas requiring insurer build-out, such as captive adjustments.
2. Can be implemented expeditiously	
3. Results in low regulatory cost and burden	
4. Tailored to risks of jurisdiction and line of business	
Weaknesses specified in ANPR	Prudential's Comments
A. Results in aggregated, not consolidated, capital	While it is true the capital results are aggregated and not consolidated, the capital results would be adjusted and scaled as appropriate to enable comparability across regimes and essentially provide a proxy for consolidation. In addition, a legal entity view provides additional transparency to the Board.
B. Prone to regulatory arbitrage and gaming	Similar to A. above, capital results would be adjusted and scaled to address regulatory arbitrage. Further, the transparency offered by the BBA would allow for the identification of all material intercompany transactions.
C. Necessitates extensive adjustments to account for inter-company transactions	The number of adjustments for intragroup transactions is relatively small and easily manageable even for the largest insurance groups, including Insurance SIFIs.
D. Requires development of large number of scalars	Calibration should follow a systematic methodology, which can be applied to any regime. A greater number of regimes requiring

scaling does not pose significant increase in difficulty, since the scaling will follow a common methodology for all regimes. In any event, the number of scalars would be limited to relevant scalar compatible regimes. A significant majority of assets of the current Insurance SIFIs are located in the United States, which would result in a substantially consistent application of the BBA. In the case of Prudential, two-thirds of our consolidated assets are in U.S. insurance operations, and we expect the number of material scalars in our BBA calculation to be limited (e.g., currently less than 5).

E. Requires legal entity level stress tests

We believe that the ability to perform statutory stress tests at the legal entity level is a strength, not a weakness, of the BBA. Although it presents operational challenges, it also provides transparency into the legal entities during times of stress, which is particularly important in the context of a regulatory regime where capital is not fungible with respect to insurance legal entities.

One additional complication of BBA is the challenge of developing robust scalars. For example:

- Many factors need to be accounted for in a single scalar (e.g., assets, liabilities, required capital and available capital).
- “Point-in-time” vs. “through-the-cycle” considerations – scalars may change through the credit cycle. For example, different regimes react differently in stressed versus normal conditions.
- Calibration using empirical data needs to consider the impact of BBA adjustments.

However, it is also worth reiterating that the vast majority of Board-supervised assets and risks are US-based, and that the scalar calibration can be improved and refined over time, in the same way that BBA adjustments and other aspects of the BBA can evolve as needed over time.

In general, we believe that the perceived weaknesses of an aggregation approach are obviated through appropriate, coherent adjustments and scaling, guided by over-arching principles that enable application to any type of insurance group and full transparency to regulators.

D. Other considerations of BBA

In this subsection, we review remaining topics concerning the BBA that were raised in the ANPR or that we believe require further clarification. These topics include the tiering of capital, definition of “insurance and insurance-related” vs. “non-insurance” entities, and the application and definition of materiality and exclusion tests.

Tiering of capital.

Prudential does not believe that the Board needs to categorize qualifying capital into tiers given the desire and benefits of minimizing adjustments to existing capital standards and audited financials, and to avoid introducing additional complexity at this early point in the development and implementation of the BBA. Furthermore, the definitions of available capital in the BBA, like the capital requirements in the BBA, must be coherent with the jurisdictional solvency regimes that apply to entities within the group. Introducing different and potentially contradictory definitions of qualifying capital undermines the strength and coherence of the BBA.

Definition of “insurance and insurance-related” vs. “non-insurance” entities.

For regulated entities, the applicable regime used for the BBA is the local regulatory capital regime. For holding companies, Prudential’s proposed treatment is to apply the same regime that is applicable to its primary entity or entities. For other non-regulated operating entities, an appropriate regime needs to be assigned, based on whether it is defined as an “insurance-related” entity or a “non-insurance” entity. For insurance-related entities, an appropriate insurance capital regime, that of its most immediate insurance parent, should be used. For non-insurance entities, Basel III should be used. Such treatment is consistent with the ANPR, except that the ANPR is not explicit in prescribing a definition for “insurance-related” vs. “non-insurance” and its subsequent treatment.

With a few exceptions noted below, we recommend that an entity be deemed “insurance-related” if it is either a subsidiary of an insurance company or it is an affiliate of a regulated insurance company that engages in activities for the benefit of, or in support of, the insurance general and separate accounts of its insurance company affiliate, or that are otherwise necessary or properly incidental to the business of the affiliated insurance company.

However, if the entity is an insured depository institution or commercial lender, an asset manager or registered investment advisor where third-party assets constitute more than 50% of its assets under management, or a broker-dealer that derives less than 50% of its revenue from the distribution of affiliated insurance products, then it should be deemed a “non-insurance” entity. Additionally, the Board may determine by regulation that other types of entities, based on their activities, are not insurance-related entities, so long as such determination does not contravene state insurance law, which Congress has indicated must be determinative.

Materiality and exclusion tests.

In order to minimize the amount of immaterial calculations, we recommend a set of materiality and exclusion tests to determine whether or to what extent specific legal entities and intragroup transactions should be included in the scope of the BBA. In principle, we recommend identifying entities as “immaterial” if they do not have the potential to contribute significant risk to the consolidated organization, which could be determined based on one or the other of the following tests:

- i. *Materiality test:* An entity is deemed “immaterial” if (i) it contains less than 0.5 percent of the group’s total assets;¹² (ii) it comprises less than 0.5 percent of the group’s total revenue¹³; and (iii) the entity has no legal or contractual recourse to the group (*e.g.*, no affiliate guarantees to the entity).
- ii. *Exclusion test:* An entity may be excluded from the BBA if (i) it has less than \$100 million in total assets; (ii) it has less than \$50 million in revenue; and (iii) the entity has no legal or contractual recourse to the group.

We suggest that simplified capital approaches be adopted for those immaterial entities that meet all 3 criteria of the above “materiality test”, such as the use of the insurance capital ratio of its direct parent even if the immaterial entity is a non-insurance subsidiary. The Board should, in addition, allow insurers to completely exclude small entities that meet the above “exclusion test” from the BBA calculation unless their inclusion would not pose any undue operational burden. Application of these tests would reduce regulatory burdens associated with performing legal entity level BBA calculations where the size and risks of the legal entity are by definition immaterial to the group’s capital position.

¹² Consistent with definition of materiality as discussed in the NAIC Insurance Holding Company System Regulatory Act (<http://www.naic.org/store/free/MDL-440.pdf>) – Information regarding an insurer’s investments/transactions need not be disclosed if the information is not material – as defined by “one-half of one percent (0.5%) or less of an insurer’s admitted assets.

¹³ Excluding any extraordinary one-time transactions. Exclusions must be reported and may be subject to regulatory review.

C. Comments on the design of the proposed Consolidated Approach.

As explained above, Prudential believes that the BBA, rather than the CA, is the better capital framework to apply to all Board-supervised insurers and would better meet the Board's stated supervisory objectives. The CA proposed in the ANPR is presented at a very conceptual level and lacks many details that will be important to understand before fully assessing the feasibility of the CA, which underscores how complicated design of the full framework may be. Nonetheless, a CA based on GAAP accounting, with appropriate adjustments, could, potentially, be a feasible approach to a group capital standard for insurers. We provide below certain key considerations that we believe will be essential in the design of a CA appropriately tailored to the business and risks of insurance groups, if the Board determines to continue to pursue its development.

Key overarching considerations.

Any CA that is developed must properly take into account certain key principles, including: the long-term nature of insurance liabilities, prudent risk mitigation measures that are built into insurance contract features and typically deployed in the management and regulation of insurance companies, and the inapplicability for insurance holding companies of the "source of strength" model that applies to bank holding companies. The CA must also apply appropriate definitions of available capital reflecting loss absorption capacity, and of required capital, reflecting the risks borne by insurance companies and the way these risks manifest themselves, including the fundamental aspect of risk diversification in insurance.

The Board states that it will use risk weights and factors that are appropriate for the longer-term nature of *most* insurance liabilities. There are generally no truly "short-term" insurance liabilities: although property and casualty liabilities are often less long-term than life insurance liabilities, neither is generally correlated with market and other economic risks, and neither exhibits the short-term nature of bank deposit or similar liabilities. Some life insurance and annuity products do possess features that correlate with market risk, but the nature of these products (including the purpose for which most customers purchase them), and several existing risk mitigants, substantially eliminate the risk of such products actually behaving as short-term liabilities. In any case, the insurance protection is not "putable" to the insurance company. A policyholder may be able to surrender his or her policy for a cash surrender value, but that amount reflects applicable surrender charges and/or other adjustments, such as market value adjustments. Historically, due to economic, contractual and regulatory reasons, life and annuity products that permit early surrender or withdrawal are not subject to significant "run" risk and behave more like long-term liabilities. Insurance product surrender rates are generally low, stable, predictable and product-specific. Policyholder surrenders result in the loss of insurance coverage, which may be difficult or impossible to replace, and policyholders may be subject to substantial surrender charges and adverse tax impacts upon surrender of the policy; therefore, surrender may not be in the policyholder's economic best interest. Mass surrenders of an insurance company's products are not plausible due to the diverse nature of insurance products and customers (considering both product-specific and policyholder-specific idiosyncrasies), and the aforementioned considerations related to insurability and economic best interest. It is essential that the applicable risk weights and factors to be applied to insurance products for capital purposes (and for purposes of stress testing) give effect to the policyholder behavioral drivers of low surrender risk, such as motivation for obtaining and maintaining insurance protection, as well as contractual limits on withdrawals, penalties for early withdrawals, possible difficulties in obtaining comparable replacement coverage, and surrender deferral periods.

Insurers have intentionally introduced contractual risk mitigants into their insurance products precisely in order to protect against surrender and liquidity risk. Risk mitigants designed to protect the solvency and liquidity of insurers should not be turned into risk enhancers by forcing insurers to hold more capital on the false assumption that insurers would not avail themselves of contractual provisions that they bargained for.

As a general matter, prudent risk mitigation needs to be recognized in any final CA. This includes, in addition to the contractual risk mitigants mentioned above, asset-liability management, diversification among risks, hedging practices, reinsurance, and risk-sharing with policyholders. Disregarding risk mitigation would perversely fail to incentivize appropriate risk management and lead to an Insurance SIFI having to hold additional capital that is not required of other insurers with similar products and facing similar risks and exposures.

Appropriately tailoring any group capital framework to the business of insurance also requires acknowledging, and adapting the framework to, the unique way in which insurance companies are structured and regulated, including existing regulatory limits on the fungibility of capital. In particular, as indicated earlier, the “source of strength” model that applies to bank holding companies is simply not a model to be applied to insurance holding companies, which generally have very limited operations and are not required to serve as a source of liquidity for their insurance subsidiaries (absent contrary contractual arrangements or regulatory undertakings). Prudential is concerned that the CA could, in this respect, result in a bank-centric approach that would not be appropriate for Insurance SIFIs. In any event, the fungibility of capital and the location of capital among affiliates must be appropriately reflected in any CA developed for Insurance SIFIs.

Finally, we believe that the CA should not include nor effectively result in an Insurance SIFI surcharge, which would further exacerbate competitive distortions in the U.S. insurance market. Any perceived systemic risk can and should be addressed in a risk-sensitive manner through appropriately tailored capital stress testing and liquidity risk management standards, including liquidity stress testing.

Key considerations as to Qualifying Capital in a CA.

Because GAAP equity does not provide an accurate measure of an insurer’s loss absorption capacity, adjustments will be needed in order to produce a meaningful and appropriate measure of Qualifying Capital. Two key adjustments relate to the inclusion in Qualifying Capital of margins in reserves, and the removal from Qualifying Capital of the unrealized gains/losses recorded in GAAP AOCI.

Margins in reserves

Qualifying Capital should reflect the insurer’s full loss absorption capacity. This is primarily achieved with the adjustment of GAAP insurance liabilities to best estimate levels,¹⁴ allowing for the loss-absorbing margins in reserves to be recognized in Qualifying Capital.¹⁵ Unlike banks, whose liabilities represent “best estimates” of deterministic liabilities, the net GAAP liabilities for insurance contracts generally include an element of conservatism over and above the best estimate of the liabilities. This margin above the best estimate stems from required conservatism in some of the valuation assumptions and other GAAP requirements which essentially increase the liability to defer the recognition of day 1 profits over the lifetime of the insurance contracts. An insurance company’s net GAAP liabilities are supported by invested assets. The net GAAP liability and the supporting assets exceed the expected amount needed to fulfill the insurance obligations, but that excess is not recognized in GAAP equity. These margins (and the assets supporting them) are available to act as a cushion against shocks to Qualifying Capital and should be included as Qualifying Capital (and as Qualifying Capital of the highest tier, if tiering is applicable). As the purpose of these margins is

¹⁴ Best estimate liabilities (“BEL”) are defined within GAAP’s Loss Recognition Testing (“LRT”) rules. BEL is based on the insurer’s best estimate assumptions and discount rates that reflect the assets supporting liabilities (asset earned rate and future reinvestment yields, adjusted for expected defaults and investment expenses). Other liabilities not subject to LRT can nonetheless be restated to best estimates using straightforward GAAP-anchored adjustments.

¹⁵ A life insurance company’s reserves consist of two components that are established at the inception of the contract: (1) “best estimate” of the present value of future benefit payments, net of current and future premiums and all expenses; and (2) a “margin” which covers unexpected losses. Depending on the type of product and accounting rules, the margin may be driven by multiple items, such as conservatism in assumptions, risk margins, and/or deferred profits. Insurance company reserves (both the best estimate and margins) are backed by invested assets on the balance sheet.

precisely to provide additional resources to absorb losses that might exceed “best estimates”, they clearly should constitute Qualifying Capital.

AOCl Adjustment

The measurement of Qualifying Capital should recognize the asset-liability management (“ALM”) that underpins the insurance business model. Insurers invest in high quality assets and hold them to maturity to support generally long-term insurance liabilities. Insurers hold a much greater proportion of long-dated available-for-sale (“AFS”) securities than banks and this is an important part of insurers’ ALM risk management. Market value changes should be relevant only to the extent that an asset is bought or sold. An asymmetric treatment of assets and liabilities in the valuation of Qualifying Capital would likely lead to artificial volatility and pro-cyclicality. By excluding from Qualifying Capital the unrealized gains/losses recorded in GAAP AOCl, symmetry between assets and liabilities can be achieved, thereby eliminating artificial volatility and pro-cyclicality. Not removing AOCl in the calculation of Qualifying Capital would likely lead to a misleading representation of an insurance group’s capital position, as capital adequacy at any time may be artificially overstated or understated depending simply on the movement of interest rates and credit spreads.¹⁶ Any concerns with potential risks of ALM mismatch would be better and more efficiently addressed through stress testing and/or liquidity risk management requirements, including liquidity stress testing, as opposed to attempting to handle such risks through capital requirements (particularly requirements based on a blunt factor-based approach).

Other potential sources of Qualifying Capital

Other loss-absorbing capital should be recognized in Qualifying Capital under the CA, including:

- Certain capital market instruments, depending on their structure and loss-absorbing characteristics, including: perpetual preferred stock (whether or not dividends are cumulative); surplus notes; junior subordinated debt; and contingent convertible securities;
- Deferred tax assets (“DTAs”) because they have value on a going concern basis and retain some value in winding up; and
- Other appropriate loss-absorbing resources.

Tiering of Qualifying Capital

The ANPR explores the idea of tiering capital resources. We believe that establishing tiers of Qualifying Capital is unnecessary as it conflates capital and liquidity by imposing restrictions and requirements around capital resources that are aimed at ensuring appropriate liquidity when needed. Given the nature of unexpected losses for insurers, which relate to both short term “event” risks and long term “slow bleed” risks – such restrictions on Qualifying Capital would be unnecessary and inappropriate. Instead, Prudential believes that all tangible loss-absorbing resources should be counted as Qualifying Capital, and that an appropriately tailored liquidity risk management framework for Insurance SIFIs should distinguish those assets required to meet liquidity demands based on appropriate criteria.

¹⁶ It should be noted that the IAIS is exploring what it calls a “GAAP with Adjustments” valuation approach in which an AOCl Adjustment would be applied to address asymmetry in the valuation of assets and liabilities. The AOCl adjustment would be applied to capital resources such that assets and liabilities would both be measured on a more consistent basis, thus reducing unintended volatility in capital.

Key considerations as to required capital in the CA.

The Board indicates that the CA would determine capital requirements using “relatively crude” risk segments and factors. Prudential recommends that the approach be appropriately aligned to the risks borne by the insurance group. The segments to which the factors are applied should be aligned to drivers of risk and should not be prone to overstating or understating risk, under either normal or stressed conditions. Ensuring that the factors and segments are appropriate will thus require extensive effort, including in-depth development and testing. This is especially important considering the wide range of insurance products and associated risks that the Board must ensure are appropriately captured in the framework. Beyond the operational challenges of developing factors that are appropriate across the broad range of diverse products and risks, formulating new and potentially inconsistent insurance risk factors could lead to incomparability and the mismeasurement of risk, along with capital inefficiencies (since risks borne by insurance companies are already subject to capital being held at the insurance legal entity level). The construction of entirely new risk charges and standards is, Prudential believes, unnecessary and could lead to unintended consequences. Considering these challenges, the CA risk factors should be based on RBC rules since those have been developed, refined and tested over many years. Use of RBC-based factors has the appeal of being readily implementable, easily maintained, and comparable with the BBA.

To the extent that the Board wishes to develop new factors, we believe it is important to recognize the following:

- *The exposure bases to which risk factors apply must be appropriately aligned to the drivers of a particular risk.* For instance, the face amount of life insurance in-force is an appropriate basis for mortality risk exposure as it is aligned to the way the risk will manifest itself for a life insurance company (*i.e.*, through death benefit payments). This is one example out of the range of products and risks in the U.S. insurance market that the Board must evaluate in developing appropriate risk factors and segments.
- *Insurers should not be subject to capital charges for risks that are passed on to policyholders.* Certain insurance products offered by U.S. insurance companies contain structures and/or features that pass risk on to the policyholder. For instance, policyholders bear the asset risk associated with separate account assets, and participating insurance policies provide for policyholder participation in the experience of the insurance company with respect to certain defined risks through a policyholder dividend mechanism or similar experience/risk sharing features. Separate account assets for which the insurer does not bear any asset risk should not be subject to risk charges (general account guarantees of separate account assets would be captured through appropriate risk charges applied to general account assets). From a GAAP accounting standpoint, there is a separate account liability on the balance sheet that is necessarily equal in amount to the separate account assets, so the insurance company is fully insulated from any fluctuations in the value of these assets. Separate account assets – whether guaranteed or not – should get zero risk weighting (assets backing guarantees would be treated in line with other general account assets).

Participating insurance policies, which pass risks on to policyholders through the participation mechanism, should be subject to risk charges commensurate with the actual, reduced risk they pose to the insurance company, which in certain cases would result in a zero risk charge at a given calibrated severity level. Assets and liabilities associated with fully participating policies, such as those associated with a closed block, generally pose minimal or no solvency risks for insurers, as the underlying risks associated with these policies are in large measure borne by policyholders or are otherwise subject to significant cushions and protections. Any timing differences between the occurrence of an adverse event and the pass-through of that experience to policyholders (*e.g.*, through adjusting participating dividends)

would be a temporary liquidity concern only and should be addressed through liquidity risk management measures and not translate into additional capital requirements.

- *The required capital framework must appropriately tailor asset/credit risk charges for insurance.* Policy loans should also receive zero risk weighting. Policy loans are essentially contra-liabilities and reflected as assets on an insurer's balance sheet since they reduce dollar-for-dollar the cash value and death benefit of the subject policies – no counterparty or credit risk is involved. As with participating policies, any potential timing issues in respect of policy loans should be handled through liquidity risk management measures.

Corporate bonds held by insurers should be risk-weighted appropriately. Insurers, unlike banks in many respects, typically invest in highly investment grade bonds that are held to back long-term liabilities. Because bonds held by insurance companies are generally limited to backing long-term liabilities, risk factors for high-grade bonds should be based on probability of default and loss given default.

- *The required capital framework must appropriately reflect fundamental aspects of insurance risk and risk diversification.* Insurance risks must be appropriately reflected in any insurance group capital standard. The amount of risk capital required to withstand insurance shocks (e.g., mortality, longevity, lapse, morbidity/disability, natural catastrophes, etc.) should reflect the benefit of diversification between insurance risks and other risks, such as financial risks. The CA should be appropriately calibrated to reflect the probability of concurrent insurance and market and other economic stresses. Required capital should reflect modest factor calibrations so as not to overstate risk at a global level, considering the diverse nature of risks insurance groups are subject to. To the extent that risk diversification is not taken into account explicitly, the CA factor calibrations must do so implicitly. Calibration of required capital may need to be modest given the initially simple, factor-based design of the CA, which would not be able to explicitly take into account the diversity of risk exposures within an insurance group or across the industry. In addition, modest calibration is appropriate to avoid arbitrage and competitive distortions across firms subject to different regimes. Given the simple and blunt nature of a factor-based capital requirement, risk sensitivity is best evaluated through appropriately designed capital stress testing and liquidity stress testing.

D. Considerations related to the timing of capital standards development and implementation

As it develops its insurer capital framework, it is essential that the Board also consider establishing an appropriate supervisory approach for the framework's implementation, application and enforcement. The significant differences between insurers' business models and those of other financial sectors are not limited to their balance sheets; they also are evident in different internal structures, daily activities and decision-making systems and processes. In applying and overseeing the capital rules developed as a result of this ANPR, the Board must be cognizant of those differences and move forward accordingly.

Once developed, we expect that the implementation, application and enforcement of this insurer capital framework will likely take place via the Board's prudential regulation and oversight structure. In that regard, Prudential has also submitted commentary on the Board's notice of proposed rulemaking on enhanced prudential standards.¹⁷ The issues of concern we raise in that commentary are also applicable to the eventual implementation, application and enforcement of any insurer capital framework adopted by the Board. We ask that you consider those issues, incorporated here by reference, for your consideration.

¹⁷ Letter from Robert M. Falzon to Robert deV. Frierson at 13-16 (Aug. 17, 2016), *available at* https://www.federalreserve.gov/SECRS/2016/August/20160818/R-1540/R-1540_081716_130449_332400080474_1.pdf.

* * *

In closing, we thank the Board for its consideration of our views. We are available for further discussion on any of these matters at your convenience.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Robert Falzon", with a long horizontal stroke extending to the right.

Robert M. Falzon
Executive Vice President and Chief Financial Officer

cc: Thomas Sullivan
Linda Duzick

Appendix 1

The ANPR identifies several objectives and goals the Board believes are important in designing and applying capital frameworks for Board-supervised insurers, and also identifies key strengths and weaknesses of the BBA and CA. The chart below identifies these objectives, goals, and purported strengths and weaknesses, and briefly explains for each one why the BBA would be viable and optimal for all Board-supervised insurers and, on balance, better realize the Board's objectives and goals.

<i>Supervisory objectives and goals identified by the Board for insurance group capital regulations are met by BBA whether applied to Insurance SIFIs or Insurance IDIs</i>	
Regulatory capital framework for Board-supervised insurers is intended to ... “ensure that the institution has sufficient capital, commensurate with its overall institution-wide risk profile to absorb losses and continue operations as a going concern throughout times of economic, financial, and insurance-related stress (<i>e.g.</i> , morbidity, mortality, longevity, natural and man-made catastrophes);”	Using RBC and other jurisdictional capital rules in the BBA meets each of these objectives, including for Insurance SIFIs, especially if the BBA is coupled with capital and liquidity stress testing.
“to serve as a source of strength to any subsidiary depository institutions”	No Insurance SIFIs currently own IDIs, and if any were to acquire an IDI, applying bank capital rules to the IDI as contemplated under the BBA would accomplish this goal
“to substantially mitigate any threats to financial stability that the institution might pose”	The mitigation of any perceived risks to financial stability will be achieved by ensuring that Board-supervised insurers are adequately capitalized and maintain appropriate liquidity, whether the BBA or CA is used, and, in both instances, calibrated through stress testing. Local insurance capital rules are consistent with and promote financial stability.
“a capital framework should take into account all material risk types (insurance and non-insurance) in these institutions”	The BBA captures risks associated with insurance activities, as well as non-insurance activities and activities with no formal capital regulations, and supports multiple accounting and solvency regimes. Moreover, the use of local capital regimes – constantly evolving in response to market and industry changes – ensures the BBA will remain tailored over time.
“The framework should strike a reasonable balance between simplicity and risk sensitivity. Achieving this balance will help ensure that risks are accurately captured while minimizing regulatory burden and increasing comparability and transparency across firms.”	Applying new insurance risk factors and segments (potentially inconsistent with state-based capital rules) to the small number of Insurance SIFIs (currently only two) increases complexity of capital requirements for Insurance SIFIs (who will continue to also be subject to state-based capital regimes), and will decrease comparability across firms. It will be difficult, and perhaps impossible,

	<p>to adequately compare the group capital of Insurance IDIs and Insurance SIFs where two distinct frameworks are being applied; comparability between Insurance SIFs is of questionable usefulness where the set of firms being compared is currently comprised of two relatively dissimilar firms.</p> <p>RBC and analogous foreign capital requirements of regulated insurers have continually been refined through decades of insurance supervisory experience to reflect risk sensitivity, and will continue to be refined as insurance products and risks evolve, which the BBA would by design capture.</p> <p>The construction of a new and distinct CA, which is contemplated to increase in granularity, will not achieve simplicity, and is initially contemplated to exhibit “limited risk sensitivity.”</p> <p>The use of disparate capital standards creates substantial uncertainty and complexity for firms – and their supervisors – since firms could potentially be subject to one standard at one time and another thereafter (or to two standards simultaneously), creating substantial costs associated with having to switch between standards. Application of the CA could also result in duplicative and potentially inconsistent regulations at the federal and state level.</p>
“the capital framework should take account of risks across the entire firm – in the holding company, in regulated subsidiaries, and in unregulated subsidiaries.”	<p>The BBA is designed to accomplish this, whether for Insurance SIFs or Insurance IDIs. Insurance holding companies are generally small and engage in very limited activities, and are not a “source of strength” for insurance subsidiaries; risks at an Insurance SIF’s holding company should be easily accounted for under the BBA. RBC and analogous foreign insurance capital regimes already take account of insurance risks in regulated subsidiaries. As to “unregulated” subsidiaries, as noted, the BBA is designed to apply Board capital rules to such entities that would properly take account of their risks.</p>
“The framework also should be executable in the short-to-medium term.”	<p>The construction of a new insurance group capital regime from scratch will likely take considerable time. The Board acknowledges that the CA will not initially be granular enough and will increase in complexity over time; the framework could accordingly be subject to significant revisions for years to come, which will lead to uncertainty</p>

	among Insurance SIFIs and investors and lack of comparability over time. The BBA is executable in the short-to-medium term.
“The capital framework also should be based on U.S. regulatory and accounting standards and not foreign regulatory and accounting standards ...”	<p>The Board has stated its preference for the adoption of a capital framework that relies on audited financial statements, but that does not rely upon internal models. The adoption of the BBA would be consistent with this objective. While the CA may begin with audited GAAP statements, it will likely rely heavily on adjustments to GAAP that are critical to enable comparability in substance across institutions and these adjustments likely would require use of some non-audited financial information. The BBA will require adjustments and scaling for subsidiaries that use foreign accounting standards, although the CA would also require adjustments at some level when consolidating foreign subsidiaries.</p> <p>A significant majority of assets of the current Insurance SIFIs are located in the United States, which would result in a substantially consistent application of the BBA. In the case of Prudential, two-thirds of our consolidated assets are in U.S. insurance operations, and we expect the number of material scalars in our BBA calculation to be limited (e.g., currently less than 5).</p>
“the framework should contribute to the stability of the financial system and should serve as a good basis for a supervisory stress test regime ...”	The BBA can accommodate stress testing at the group and entity level. The ANPR expresses concern about stress testing at the entity level, but legal entity level stress tests are arguably a more accurate measurement compared to consolidated balance sheet stress testing that can mask substantial weaknesses in a single entity when consolidated with others.
“the framework should be as standardized as possible, rather than relying predominantly on a firm’s internal capital models. Greater standardization will produce more consistent capital requirements, enhance comparability across firms, and promote greater transparency.”	The BBA in principle accomplishes all of these objectives with respect to Board-supervised insurers. The BBA would be based on current capital requirements that all insurers, including Insurance SIFIs, are subject to; applying a unique CA capital framework to a small number of U.S. insurers would in no way promote comparability, consistency, transparency or standardization. Given the larger pool of insurers involved and consistent framework, the BBA provides far greater comparability than the CA. Neither the BBA nor the CA would rely on internal models. In addition, use of a CA applied to a small number of firms would likely make it difficult for investors and other stakeholders to understand the risk and

	capital position of the affected firms, and prevent comparability with other participants in the marketplace.
<i>Key strengths and weaknesses</i>	
<p>“The key weaknesses of the CA include the following: (1) the initially simple design of the CA would result in relatively crude risk segments and thus limited risk sensitivity; and (2) substantial analysis would be needed to design a set of risk factors for all the major segments of assets and insurance liabilities ...”</p>	<p>These are significant weaknesses. Premature application of a capital framework with crude risk segments and limited risk sensitivity would defeat many of the Board’s key supervisory objectives, and could lead to unintended consequences. The time it will take to design a set of risk factors is not consistent with the Board’s goal of being executable in the short-to-medium term. The BBA would leverage existing, well-tested risk factors developed by insurance regulators, and could be implemented relatively quickly.</p>
<p>“The key strengths of the CA include the following:</p> <ul style="list-style-type: none"> • (1) it has a simple and transparent factor-based design; • (2) it covers all material risks of [Board-supervised insurers]; • (3) it is a fully consolidated framework that has the potential to reduce regulatory arbitrage opportunities and the risk of double leverage; • (4) it would be relatively expeditious for the Board to develop and for institutions to implement ...and • (5) it would provide a solid basis upon which to build consolidated supervisory stress tests of capital adequacy ...” 	<p>As noted, the initially simple design of the CA is likely to change and become more complex, and application of a framework with crude risk segments and limited risk sensitivity could lead to unintended consequences.</p> <p>As noted, the BBA would also cover all material risks. Reliance of the BBA on local regimes with different underlying accounting frameworks is beneficial, since local regimes are already tailored to the markets they serve and the products and risks therein. The BBA could provide a group-wide framework that appropriately reflects the heterogeneity of insurance. The CA would not provide insight from a legal entity viewpoint.</p> <p>The ANPR cites regulatory arbitrage as a concern regarding the BBA, but this concern does not acknowledge simple adjustments that the Board could make to legal entity level measurements or the scalars applicable to foreign regimes to address any arbitrage concerns. Furthermore, the transparency features of a BBA would allow for the ready identification of any intercompany transactions aimed at regulatory arbitrage. However, an initially simple CA based on broad bucketing and factors could actually result in arbitrage toward riskier products within a single bucket. Under such a CA, all products within a single bucket would be subject to the same risk factor regardless of underlying differences in product design or risk gradation and the resulting liability. The BBA would not produce this same risk of arbitrage given reliance on jurisdictional regimes that are tailored to the relevant products</p>

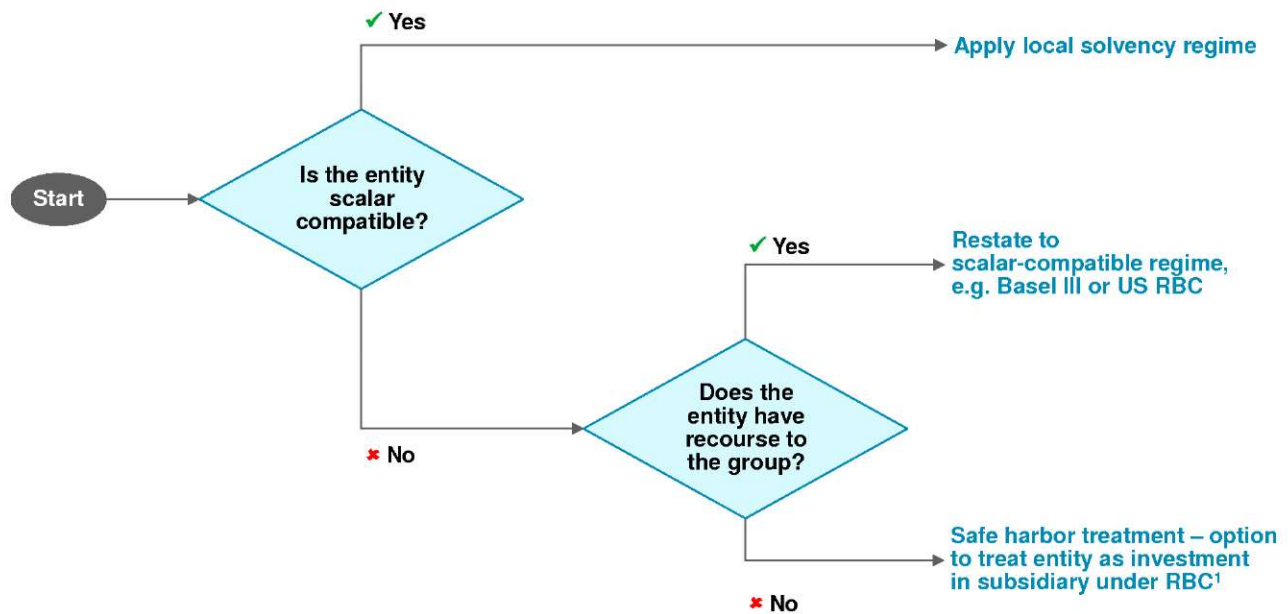
	<p>and risks in each market. Risk sensitivity can be further evaluated through capital and liquidity testing for Insurance SIFIs.</p> <p>As noted, achieving the right level of risk granularity in the CA will likely take considerable time and field-testing.</p> <p>As noted, the BBA can be stress tested using the Board’s macroeconomic stress scenarios and an explicit insurance stress charge. The application of a cruder and less sensitive factor-based capital framework that does not provide insight into the legal entity structure of Insurance SIFIs could, however, pose challenges for conducting reliable stress tests.</p>
<p>“[Insurance SIFIs] ... tend to prepare financial statements under U.S. GAAP, thereby making a consolidated capital requirement less burdensome to compute.”</p>	<p>This is a negligible consideration given the likely extensive costs and time required to build new systems and collect additional data and records, and hire or train new personnel, in order to comply with a new capital framework.</p>
<p>“the BBA may not capture the full set of risks [Insurance SIFIs] impose on the financial system without significant use of adjustments and scalars ...”</p>	<p>As noted above, application of adjustments and scalars under the BBA should not be overly complicated for Insurance SIFIs; the ANPR exaggerates the extent to which Insurance SIFIs are complex and might require extensive adjustments. In any event, the efforts and time it will take for the Board to devise proper adjustments and scalars to be applied to Insurance SIFI and Insurance IDIs will likely pale in comparison to the time, efforts and cost it will require to construct a completely new CA-based insurance group capital regime.</p>
<p>“The key strengths of the BBA include the following: (1) it efficiently uses existing legal entity level regulatory capital frameworks; (2) it is an approach that could be developed and implemented expeditiously; (3) it would involve relatively low regulatory costs and burdens for the institutions; and (4) it would produce regulatory capital requirements that are tailored to the risks of each distinct jurisdiction and line of business of the institution.”</p> <p>“the BBA is standardized, executable, applies U.S.-based accounting principles for U.S. legal entities, accounts for material insurance risks, strikes a balance between risk sensitivity and simplicity, and is well-tailored to the business model and risks of insurance.”</p>	<p>These are significant and important strengths that would equally apply to Insurance SIFIs if the BBA were applied to them.</p>

<p>“The key weaknesses of the BBA include: (1) at the top-tier level, it is an aggregated, but not a consolidated capital framework “</p>	<p>The Board does not identify why this is a weakness vis-à-vis insurance companies. Using a consolidated approach does not necessarily provide a true picture because any excess capital in a regulated insurance company may not be available to satisfy the needs that may exist elsewhere within the group – whether in a regulated or unregulated entity. The current insurance regulatory framework recognizes these constraints and therefore provides for the regulation of insurance companies on a stand-alone basis.</p>
<p>“ (2) it would not discourage regulatory arbitrage within an institution due to inconsistencies across jurisdictional capital requirements and also may be vulnerable to gaming through techniques such as double leverage (<i>i.e.</i>, when an upstream entity issues debt to acquire an equity stake in a downstream entity); (3) it would need to account for inter-company transactions, which may result in extensive adjustments; (4) it would require the Board to determine scalars regarding a large number of state and foreign insurance regulatory capital regimes; and (5) it likely would require legal entity level stress tests, presenting challenges to appropriate reflection of diversification and inter-company risk transfer mechanisms and other transactions.”</p>	<p>As noted, simple adjustments may be made to entity level measurements or the scalars applicable to foreign regimes to address any arbitrage concerns. The section on BBA design in this comment letter addresses each of these purported weaknesses. Prudential believes a properly constructed BBA can be developed that addresses these concerns. Moreover, an initially simple CA based on broad bucketing and factors could result in arbitrage toward riskier products within a single bucket.</p>

Appendix 2

Supplemental illustrations of recommendations relating to the BBA

Figure 1: Capital treatment for scalar compatible and non-scalar compatible regimes



1. Treat GAAP equity (ex. intangibles) as available capital and apply a 50% risk charge for affiliate insurance entity (more conservative risk charge under US RBC)

Figure 2: Illustration of adjustments for U.S. Term and ULSG captive

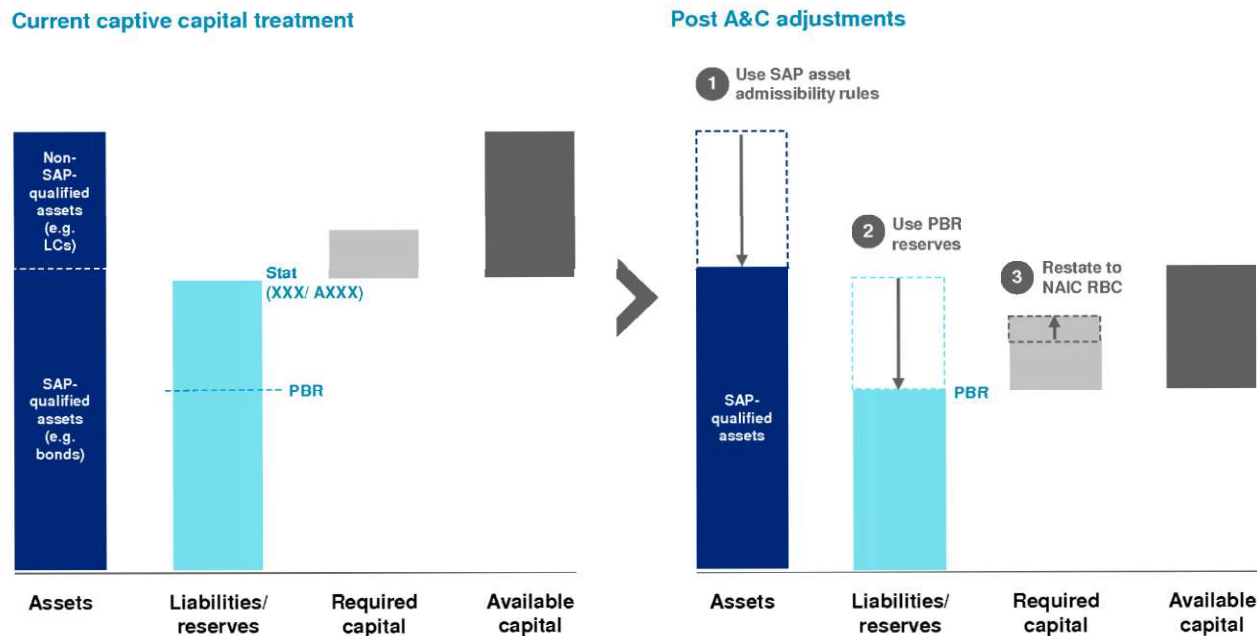


Figure 3: Illustration of adjustments for VAs

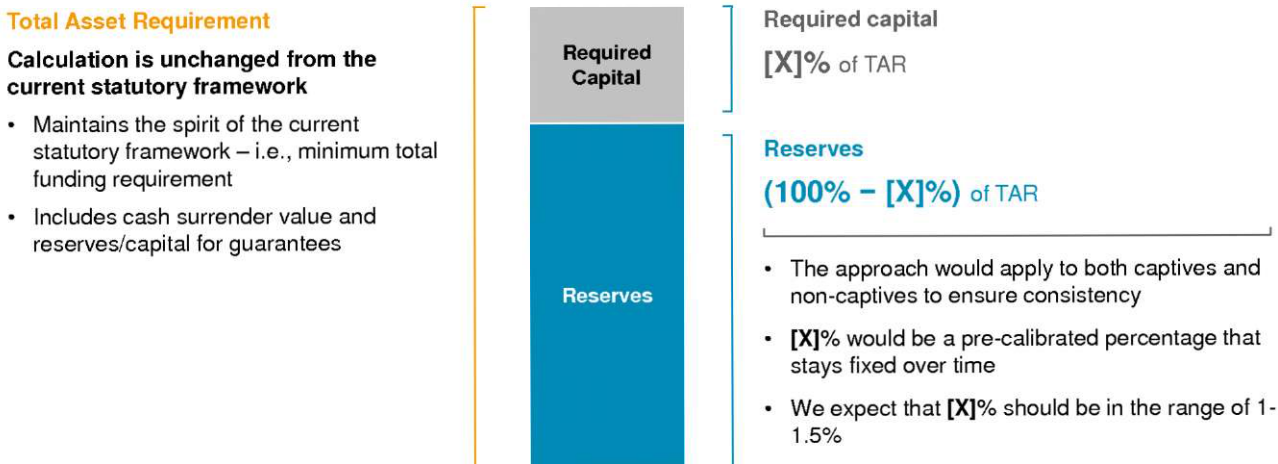


Figure 4: Illustration of investment in affiliate adjustment

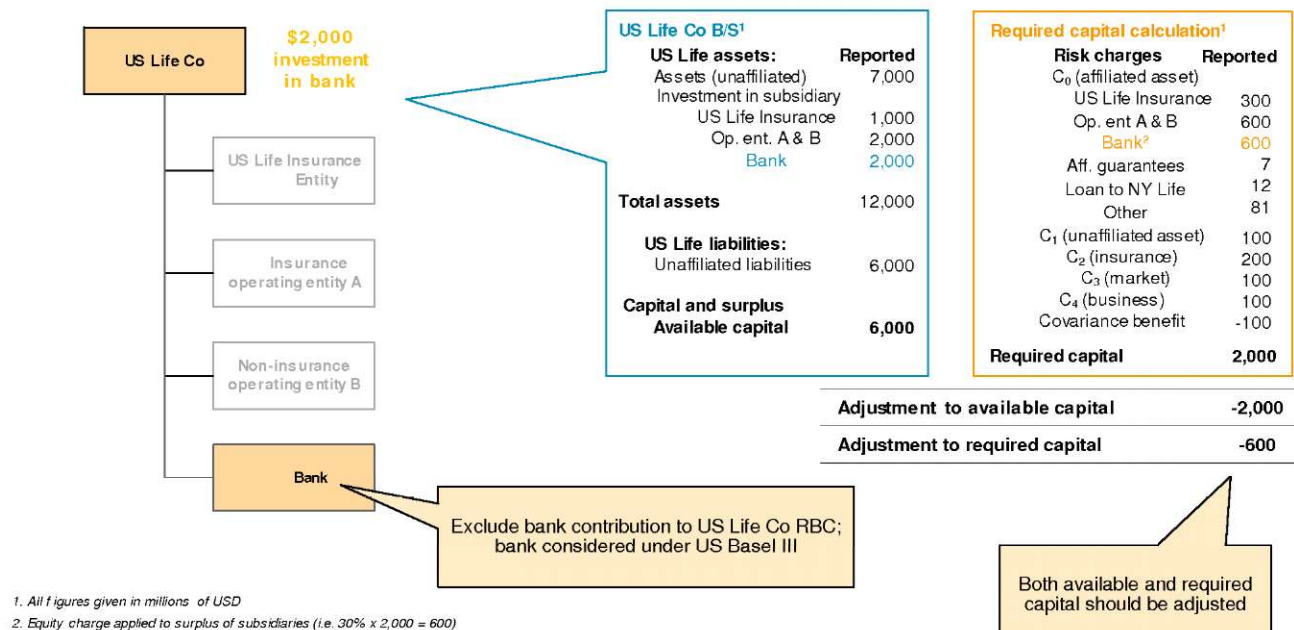


Figure 5: Illustration of intragroup guarantee adjustment

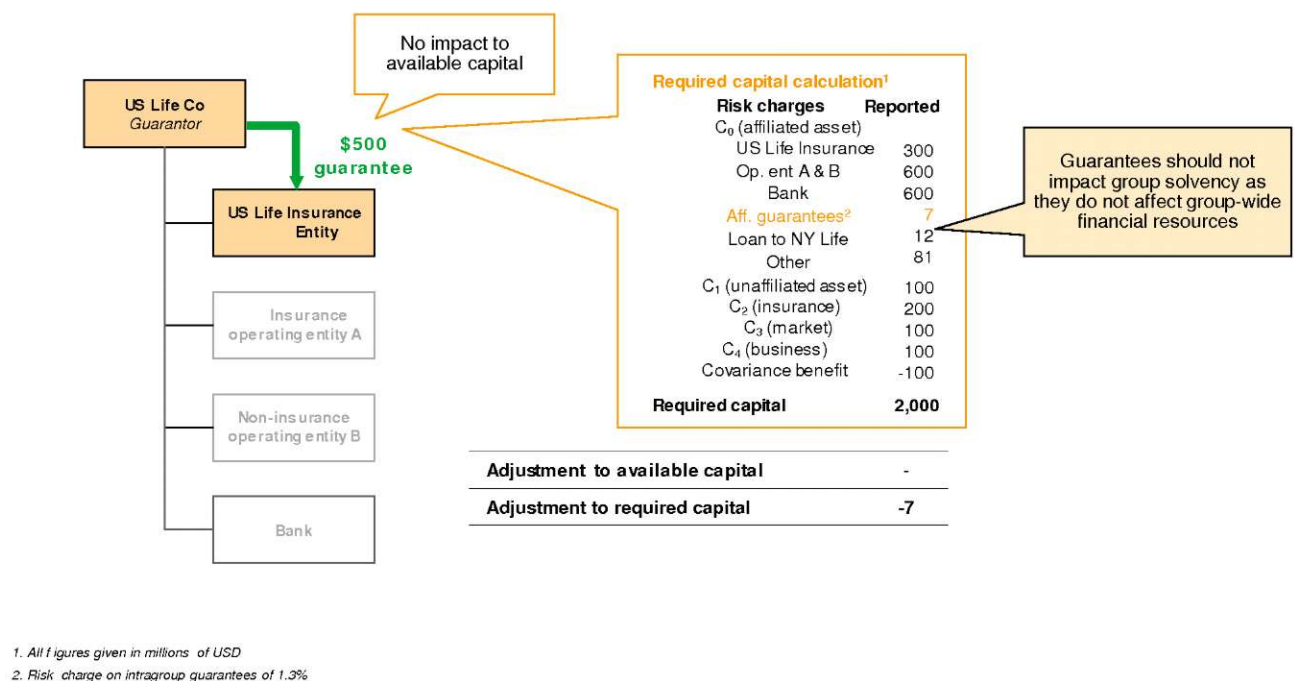
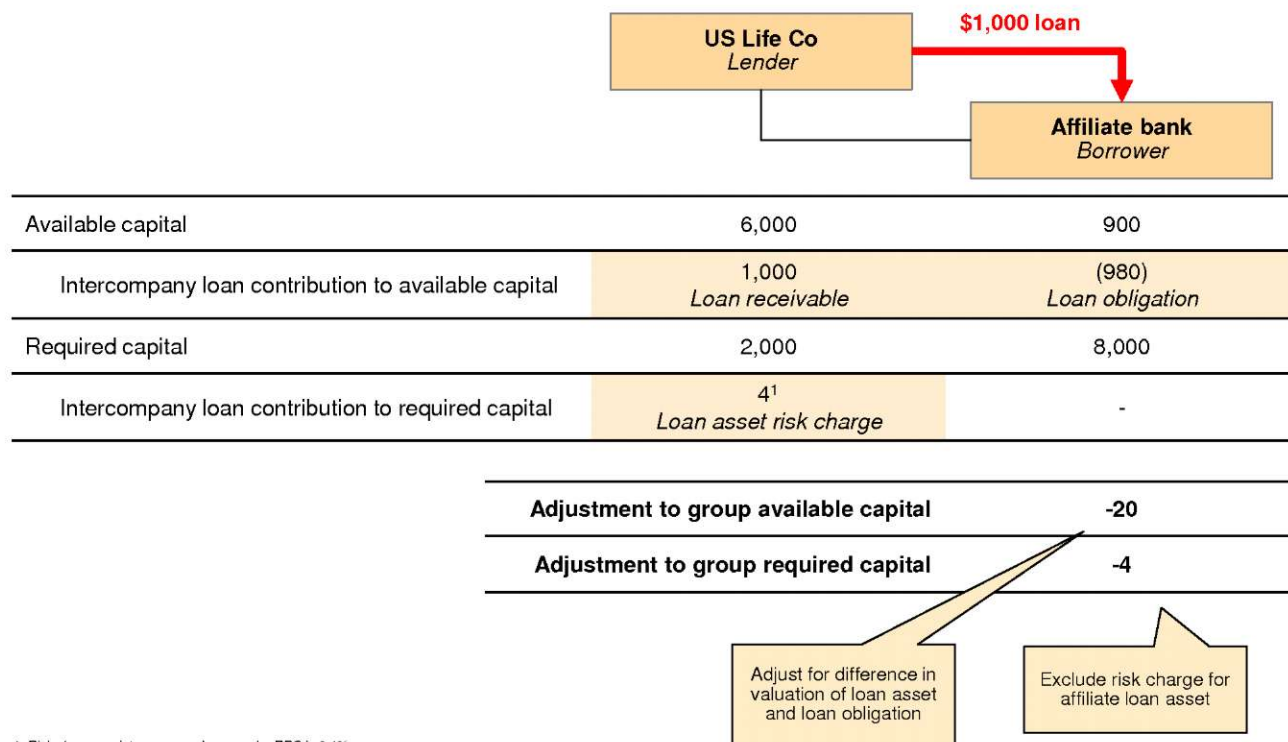


Figure 6: Illustration of affiliate loan adjustment



1. Risk charge on intercompany loans under RBC is 0.4%